

# NAVAL POSTGRADUATE SCHOOL MONTEREY, CALIFORNIA



## THESIS

**PRIVATIZATION IN INDONESIA: ONE  
ECONOMIC STRATEGY TO ACCELERATE  
ECONOMIC GROWTH**

by

Benyamen N. Supit  
June, 1996

Principal Advisor:  
Associate Advisor:

Robert E. Looney  
Peter C. Frederiksen

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ACCELERATE ECONOMIC GROWTH**

Benyamen N. Supit  
Commander, Republic of Indonesia  
B.S., Indonesian Naval Academy, 1970

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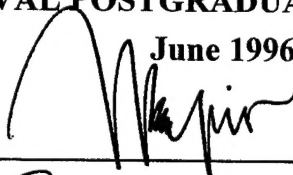
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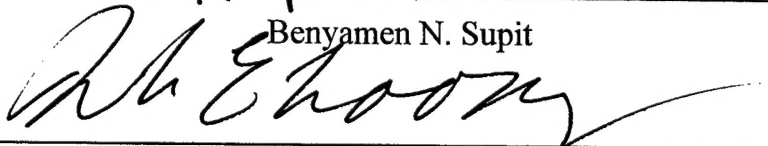
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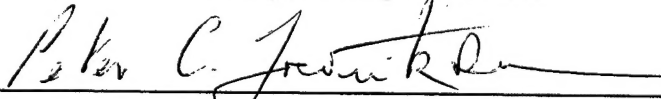


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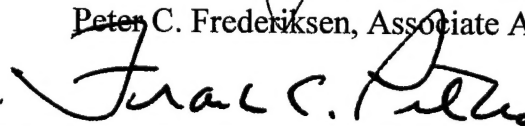
Approved by:



Robert E. Looney, Principal Advisor



Peter C. Frederiksen, Associate Advisor



Frank C. Petho, Acting Chairman  
Department of National Security Affairs





## **ABSTRACT**

This is a study of privatization in Indonesia. Privatization is defined as the transfer of ownership control or functions from the public to a private sector. After an overview of the terminology used in describing privatization and the current theory of privatization, this thesis examined four performance factors of Indonesia's economy: crises and reform, sustaining development, the growth challenge, and public sector. The study analyzes the public enterprise's role in economic development. Further, it examines privatization purpose and the privatization process with respect to evaluation and selection of public enterprises. The study further indicates the priority for privatizing public enterprises. Finally, the author suggests considerations and requirements for management in a privatization program.



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## **I. INTRODUCTION**

### **A. INTRODUCTION**

Privatization promises that it will promote economic efficiencies through competition, improve productivity, business and investment opportunities, and falling unemployment. The growing appeal of privatization, can be traced back to the economic developments in the mid 1970s. At that time, it became apparent that privatization was a major contributor not only to economic growth, but also to social and political stability.

When a nation's output grows faster than its population, its standard of living rises. Output growth depends on the availability and quality of input, and how efficiently those inputs are combined to produce output. Output growth also depends on scientific and engineering advances that make it possible to produce more output from a given amount of inputs. There are two basic contributors involved with economic growth, public enterprises and private enterprises. Also involved is government policy, with a synergistic relationship that results in an economy's overall development and performance.

Indonesian philosophy of economic development has been based on the principle of collective cooperation. Article 33 of the 1945 Constitution, states that important production sectors which affect the lives of most people and the exploration of land, water, and natural resources should be controlled by the state. Public Enterprises (PEs) initially established by the Dutch, were after independence taken over by the Indonesian government. In addition, the Indonesian government has also established many PEs in various sectors of the economy. Through the years, the dominance of PEs in the Indonesian economy has been increasing.

In 1976, PEs in Indonesia reached 153 excluding the state banks. These enterprises can be classified into several categories. With this composition PEs and private enterprises, Indonesia has achieved an average growth of almost 7% per annum for the last twenty years.

Although Indonesia's per capita income reached US \$ 665 in 1993, Indonesia still is classified as a low income country. In 1991, the PEs sector in Indonesia consists of more than 180 enterprises, excluding subsidiaries of PEs and other enterprises owned by local

government. This represents an estimated 15% of GDP, with an employment of 1.15 million or 1.7% of the labor force.

## **B. BACKGROUND**

### **1. Geography**

The Republic of Indonesia, the world's largest island nation, lies on both sides of the Equator between south-eastern tip of the Asian mainland and Australia. It extends more than 5,120 km from east to west and 2,000 km from north to south. However, nearly four-fifths of the area consists of sea. The country consists of more than 17,000 islands that are extremely varied size and character, of which some 6,000 are inhabited.

Sumatra is the largest island, though its area is exceeded by the Indonesian segment, about two-thirds, of Borneo, Kalimantan. These islands are followed in size by Irian Jaya, then by Sulawesi, and by Java. The remaining areas are much smaller islands, comprising Bali, the Nusa Tenggara group and small scattering islands of Maluku, which lie between Sulawesi and Irian Jaya.

Difference in size reflect fundamental differences in geological structure. All the large islands except Sulawesi stand on one or the other two great continental shelves: Sunda shelf representing a prolongation of the Asian mainland, and Sahul shelf, which is covered by the shallow Arafuru Sea and links New Guinea with Australia.

Indonesia previously was known as the Dutch East Indies. It was renowned through history for its production of spices. After centuries of Dutch colonial dominance and three years Japanese occupation during World War II, a republic was proclaimed on August 17, 1945. But not until December 1948, did the Dutch formally surrender their sovereignty to an independent Indonesian state.

### **2. The People**

Some 300 ethnic groups, speaking more than 200 languages or dialects live in the archipelago. With an estimated population of 190 million in 1993, Indonesia ranks as the fourth populous country in the world, after the People's Republic of China, India, and the United States. Even though Indonesia's population growth rate had decreased over the

decades, the population continued to grow. With an annual growth rate estimated at 1.7%, the population is expected to double by 2025 (Frederick 1993, p.83). The Indonesian characteristic of seeking consensus through discussion, promotes national unity as well as cohesion within communal groups.

Indonesian's large population is very unevenly distributed. About 62% of the people are crowded onto the islands of Java, Bali, and Madura, which make up 7% of the country's total land area. Some parts of Java have very high rural population densities, with 5,000 or more people per square kilometer. In contrast is Sumatra which has 25% of nation's total area and only 19% of the total population Kalimantan with 28% of the national territory has only 4.5% of the population.

Nearly 90% of the Indonesian population is Muslim, one of the largest Muslim population of the world. About 6% of the people are Christians and 2% adhere to Hindu, principally in Bali. The remainder are Buddhist, Confucian, or other teachings. Religion in Indonesia is a complex and volatile issue. The state guaranteed tolerance for certain religions regarded as monotheistic by the government, including Islam, Christianity, Hinduism, and Buddhism, but only as long as these religions remained outside of politics.

### **3. Economy**

Indonesia's economy is predominantly agricultural, although agriculture's share of gross national product and employment has declined. Export production is important in this sector and is strongly influenced by world market condition. Throughout the 1970s, tax revenues earned from oil helped fund a growing government investment. In the mid-1980s, these revenues declined dramatically because of the glut of oil on the world market.

When tax revenues were growing rapidly, the government pursued ambitious investments in heavy industries such as steel and advanced technologies such as aeronautics. Petroleum exports and the increasing exploitation of other natural resources funded imports of machinery and raw materials vital to this rapid industrialization. Timber from Indonesia's vast rain forest, copper and nickel from remote mining sites, and traditional agricultural products such as rubber and coffee also contributed to the buoyant export earnings.

Agricultural programs brought the benefits of modern agricultural technology to millions of peasant farmers. In the 1980s new programs extended the benefits of modern agricultural techniques to other food and cash crops. This revolution created challenges as the greater diversity of crops, other than rice, and more varied conditions of cultivation made the task of increasing agricultural output more complex.

Economic ideology was a departure from the former regime's brand of socialism. The government gained complete control over most private markets, including foreign trade and bank credit. Large budget deficits and intrusive economic controls led to a mounting inflation and a stagnant economy. Learning from the mistakes of predecessor, the hallmark of the new government was fiscal and monetary conservatism. Budgets were balanced, and growth in the money supply was restricted to contain inflation.

The government itself assumed the role of industrialist by direct state investment, increasing regulations and offering special protection for favored industries. In spite of abundant and cheap labor, Indonesia's exports were still dominated by natural resources and agricultural products. The collapse of the oil market in the mid-1980s underscored the economy's weakness and forced the government to take stock of its economic policies.

From the mid-1980s to the early 1990s, a wave of reforms to promote manufactured exports significantly reduced the role of government. Private businesses seemed prepared to take up the slack. Growing manufactured exports rebounded gross domestic product. The gross domestic product had dropped in 1982. But still many major state-owned firms, labeled strategic industries, are protected from any threat of privatization.

Although available evidence on income distribution suggested that income inequality is declining, the extreme wealth of the privileged few remained a symbol of inequity and a sensitive public issue in the early 1990s. The vast majority of the population still lived in rural areas and earned a living from agriculture or from the informal sector of petty trade and other low-skilled services.

A precipitous drop in growth by the early 1980s, pointed to limits of the industrialization strategy. A new generation of reformers advocated a more limited role for the government. In the politics of economic reform, two main forces of influence within the government battled to shape economic policy. The technocrats who favored market reforms and a limited role for the government in the economy and the economic nationalists who argued that trade protection and direct government investment and regulation are necessary to contain foreign influence while sufficient resources are mobilized to modernize the economy.

#### **4. Government**

Indonesia is a constitutional republic. The constitution was promulgated on August 17, 1945 at the time of Indonesia's proclamation of independence. It provides for a unitary state and centralized form of government. The national Indonesia legislature consists of a single chamber, the House of People's Representatives or Dewan Perwakilan Rakyat (DPR). Indonesia also has a People Consultative Assembly or Dewan Permusyawaratan Rakyat (MPR). MPR ordinarily convenes once every five years, and in addition to electing the president and vice president of the republic, it also approves the general policy principle and direction of the government.

According to the constitution, there are six organs of state. Sovereignty in Indonesia is vested in the people, who exercise their will through the MPR. Full executive authority is vested in the president, who is elected by and responsible to MPR. Legislative power is shared with the DPR. The president is advised by the Supreme Advisory Council or Dewan Pertimbangan Agung (DPA), whereas the State Audit Board or Badan Pemeriksa Keuangan (BPK) exercises financial oversight. At the apex of the judicial system is the Supreme Court or Kejaksaan Agung (Jagung).

After 1965 and the destruction of the Indonesian Communist Party, the military dominated Indonesian politics. The policy priority of the government was economic development based on security, stability, and consensus. These policies brought Indonesia to a unitary state with a highly centralized governmental administration. This centralization



was seen by Indonesia's leaders as necessary in the fragmented geographical and highly plural ethnic setting with a history of regional and ethnic rebellion.

The political party system was simplified with the institution of Golongan Karya, or Golkar, the de facto government party organized around functional groups in society. Golkar compete in elections with the United Development Party (PPP) and the Indonesian Democratic Party (PDI). Because of the built-in advantage of massive government support and highly restrictive campaign rules, Golkar had emerged victorious in all national elections since 1971. The freedom of action that the government enjoyed also was enhanced by a judicial system in which the rule of law often seemed bent to the will of government.

### **C. OBJECT OF THIS RESEARCH**

The research questions are:

- How can Indonesia maintain or increase her economic growth toward, and keep pace with international economic trends in the future?
- What is the nature and role of privatization?
- Why is the public sector too weak to meet future economic challenges, and on the other hand is the private sector of Indonesia up to the challenges of a global economy?
- How will privatization contribute to the solution of Indonesia's economic problems and accelerate economic growth in a competitive and global world economy?

Based on the privatization promises, this thesis will use an analytical study methodology to examine; privatization theory, public enterprise, and private enterprise in order to answer the research questions. In addition, by utilizing analytical methodology, this thesis will examine Indonesian economic performance by comparing public and private sector contributions to economic growth. In particular, the study will examine the manner in which further privatization may contribute to growth and expansion of Indonesian economy. Through utilizing a taxonomy of privatization strategies, the study will evaluate what kinds of PEs can be most effectively privatized and what kind of PEs should be left to the government.

#### **D. ORGANIZATIONS OF THIS STUDY**

This chapter has presented an overview of the Indonesian economy and outlines the purpose of the study. Chapter II presents a brief introduction to privatization theory so that the reader and the author have a common terminology for the remainder of the study. Chapter III examines the economic performance of the Indonesian economy in both the public and private sector. Chapter IV is an analysis and evaluation of the implementation of Indonesia's privatization policies with a brief survey of international experiences in implementing privatization. Chapter IV also includes a survey of future directions of economic policy in Indonesia. In Chapter V, the author will present conclusions and recommendations.



## **II. PRIVATIZATION THEORY**

### **A. CHARACTERISTIC OF GOODS AND SERVICES**

Human beings require many different kinds of goods and services. Goods can be defined as something that has economic utility or satisfies economic wants; services can be defined as performance or conduct that assists or benefits someone or something and usually does not produce a tangible commodity. Goods and services can be classified according to two concepts: exclusion and consumption.

#### **1. Exclusion**

Goods and services have the characteristic of exclusion if the potential user of the goods can be denied the goods or excluded from their use unless he meets the conditions set by the potential supplier. The goods can change hands only if both the buyer and seller agree on the terms. Goods and services that we buy in the marketplace clearly fall into this category. All have this exclusion property.

But, there is a large number of other goods and services that do not possess this simple property. For example, a lighthouse is a valuable service for seafarer, but they do not pay the lighthouse keeper for it. The water of a large freshwater lake is another example of goods whose consumption cannot conveniently be prevented or excluded.

It should be recognized that exclusion is a matter of cost. Exclusion is feasible or unfeasible to the extent that the cost of enforcing exclusion is relatively low or high. Exclusion admits to degrees of exclusion. Exclusion from the services of a lighthouse is rather infeasible. On the other hand exclusion in the purchase of goods from a store is feasible. But, other goods cannot be classified quite so neatly.

#### **2. Consumption**

Another important characteristic of goods and services that is relevant to this study has to do with consumption. Some goods may be used or consumed jointly and simultaneously by customers without being diminished in quality or quantity, while other goods are available only for individual consumption. If goods are used by one consumer, they are not

available for consumption by another consumer. A fish and haircut are examples of a commodity and a service subject to individual consumption.

Contrast a fish or a haircut with a television broadcast, the program remains equally available for joint consumption by many users and is in no way diminished or made less useful by our act of consumption. Another illustration of joint-consumption are parks and streets. In fact, few goods are pure joint-consumption goods. Most fall along a continuum between pure individual and pure joint consumption.

### **3. Classifying Goods and Services**

The two properties, exclusion and consumption, constitute the two dimensions in Figure 1. The four corners of the diagram correspond to pure forms: first, pure individually consumed goods for which exclusion is completely feasible. Second, pure jointly consumed goods for which exclusion is completely feasible. Third, pure individually consumed goods for which exclusion is completely infeasible. Fourth, pure jointly consumed goods for which exclusion is completely infeasible. These four idealized types of goods and services are called private goods, toll goods, common-pool goods, and collective goods respectively.

The reason for classifying goods in this manner is that the nature of the goods determines whether or not it will be produced at all, and also the conditions needed to assure that it will be supplied. Private goods are consumed individually and cannot be obtained by the user without the assent of the supplier. Private goods are usually obtained by making payment. Common-pool goods are consumed individually, and it is virtually impossible to prevent anyone from taking them freely.

Toll goods are used jointly, but the users must pay, and those who won't pay can easily be excluded from enjoying the use of the goods. The more difficult or costly it is to exclude a consumer from the use of toll goods, the more likely that it is a collective commodity. Collective goods consumed jointly, and it is impossible to exclude anyone from their use, which means that people generally will not pay for them without some sort of coercion.

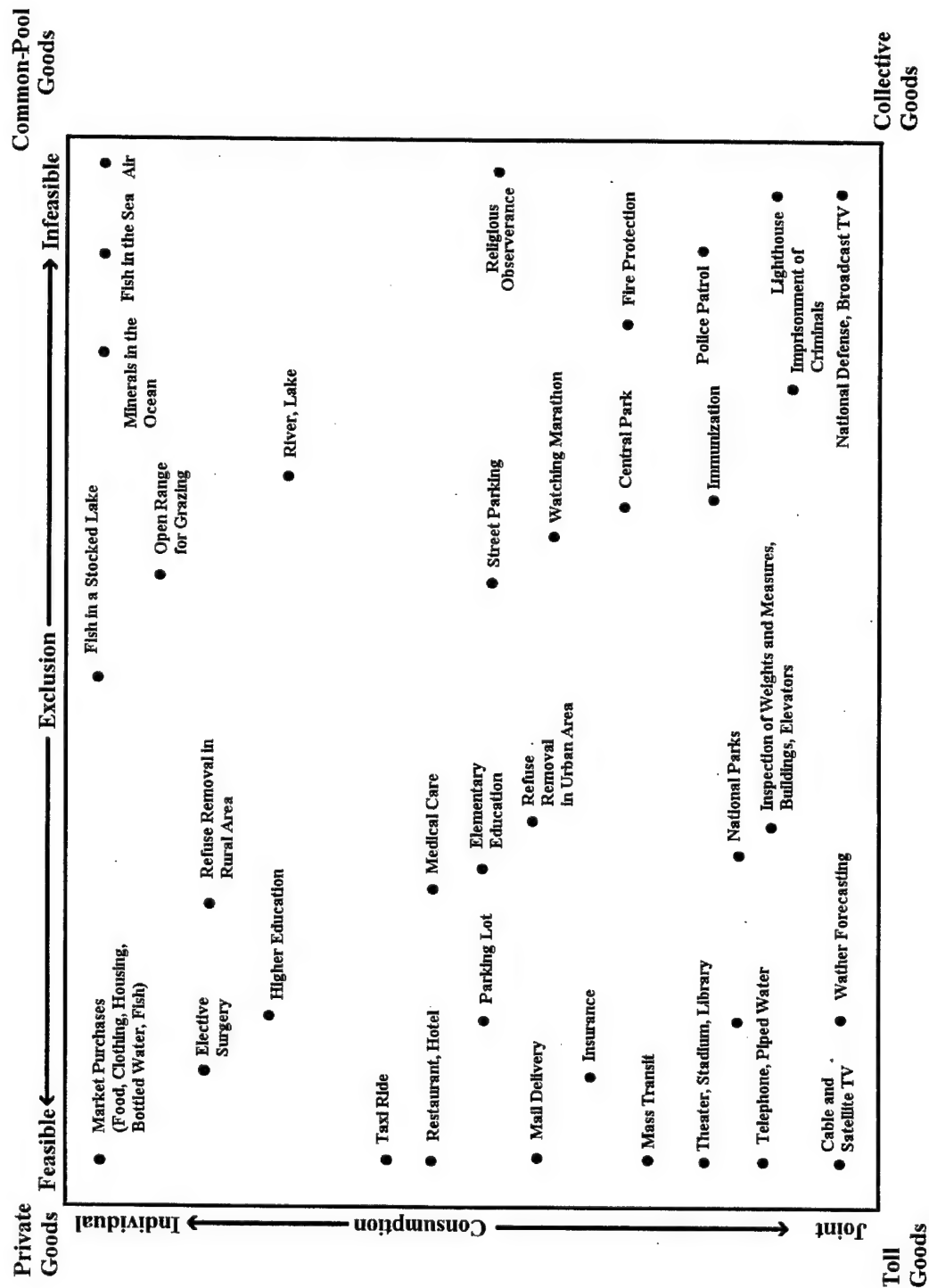


Figure 1. The Continuum Between Individual and Consumption

The goods that appear near the corners can be considered private goods, toll goods, common-pool goods, although none of them are pure or ideal types. In the upper left of the diagram appear the ordinary goods and services that are in the marketplace. They are all pure or nearly pure private goods. In the lower right are collective goods. Air pollution control is a pure form of collective goods.

Air is a common-pool good. It can be used and taken freely, but upon compression it is changed into purely private goods. Telephone service is a toll good whose quality is actually enhanced when other users consume it jointly. Electric power is a toll commodity. Mass transit is a toll commodity, taxi service is more of a private commodity, and a private automobile is a more purely private commodity.

It is clear that the nature of the goods determines the willingness of consumers to pay for it, and therefore, inevitably, the willingness of producers to supply it. Hence the nature of the goods determines whether or not collective intervention is needed to procure the goods in satisfactory quantity and quality.

**a. *Private Goods***

Private goods pose no conceptual problem of supply. This is because the marketplace provides them. Consumers demand the goods, entrepreneurs recognize the demand and produce the goods. They sell the goods to willing buyers at mutually satisfactory prices. Collective action with respect to private goods is confined to assuring their safety, for example for food, drug etc. and honest reporting such as weights and measures. Even though the market can insure the supply of private goods, sometimes governments supply them.

**b. *Common-Pool Goods***

Common-pool goods do pose a supply problem. With no need to pay for such goods, and with no means to prevent their consumption, goods will be consumed to the point of exhaustion. This will occur as long as the cost of collecting or harvesting of the free goods does not exceed the value of the goods to the consumer. No rational supplier will produce such goods, and they would exist only through the beneficence of nature. Market mechanisms cannot supply common-pool goods. The problem inherent in common-pool

goods is the danger of depletion. One way to conserve the natural supply is through collective action.

*c. Toll Goods*

Toll goods can be supplied by the marketplace. Because exclusion is readily possible, users will pay and therefore suppliers will supply the goods. Some toll goods present problems that require collective action. As the number of users increases, the cost per user decreases. The result is that it is most economical to have a single supplier. Toll goods are said to be natural monopolies. In any event, toll goods, like private goods, can be supplied in the marketplace, but in many countries toll goods are supplied by government.

*d. Collective Goods*

Collective goods pose a serious problem in the organization of a society. The marketplace is unable to supply such goods because, by their nature, they are used simultaneously by many people and no one can be excluded from enjoying them. Every individual has an economic incentive to make full use of such goods without paying for them and without contributing a fair share of the effort required to supply them. Therefore, collective contributions have to be obtained in order to assure a supply of the goods.

**B. ARRANGEMENT FOR PROVIDING GOODS AND SERVICES**

There are three basic participants in the delivery of a service: the service consumer, the service producer, and the service arranger or provider. The consumer directly obtains or receives the service. The consumer might be an individual, a household, everyone residing in a defined geographic area.

The service producer is the agent that actually and directly performs the work or delivers the service to the consumer. A producer can be a unit of government, a voluntary association, a private firm, a nonprofit agency, or consumer himself. Moreover, the service arranger is the agent who assigns the producer to the consumer, or vice versa, or selects the producer who will serve the consumer. Frequently, but not always, the arranger is a government unit.



The relationship of the three service participants is illustrated in Figure 2. The consumer, the producer, and the arranger are connected by certain flows of authorization, of service delivery, and of payment. When a city government hires a paving contractor to resurface a street with asphalt, the city is the arranger, the firm is the producer, and the people who use the street are the consumers of these particular collective goods.

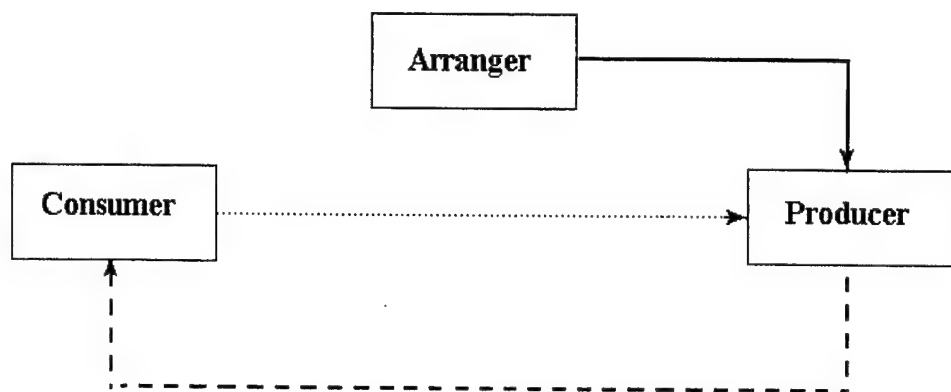
With respect to collective goods, the arranger has significant responsibilities. The distinction between providing or arranging a service and producing it is profound. With respect to many collective goods, government is essentially an arranger or provider—an instrument of society for deciding what shall be done collectively, for whom, to what degree or at what level of supply, and how to pay for it. A government that decides that a service is to be provided at collective expense does not have to produce it using government equipment and government employees.

These different arrangements arise because government or the private sector can serve as arranger or producer. This leads to four classes of arrangements:

- Government arranges and produces a service: A government service or inter-governmental agreement.
- Government arranges, the private sector produces a service: A contract, franchise, or grant.
- The private sector arranges and produces a service: A voucher, market, voluntary, or self help.
- The private sector arranges and the government produces a service: government vending.

### **1. Government Service**

The term government service denotes the delivery of a service by a government agency using its own employees. Government acts as both the service arranger and the service producer. These activities are carried out by state-owned and state-run enterprises rather than by government bureaus, but they all come under the heading of government service.



**ILLUSTRATIVE RELATIONSHIP BETWEEN CONSUMER, PRODUCER, AND ARRANGER WHERE THE ARRANGER SELECTS, ASSIGNS, AND AUTHORIZES THE PRODUCER (SOLID LINE); THE PRODUCER DELIVERS THE SERVICE TO THE CONSUMER (DASHED LINE); AND THE CONSUMER PAYS THE PRODUCER DIRECTLY FOR THE SERVICE (DOTTED LINE) IN THIS EXAMPLE**

**Figure 2. Relationship of the Three Service Participants**

## **2. Government Vending**

Someone may arrange to purchase goods and services from a government agency. They can buy rights from government for water, minerals, or timber. In essence, government is competing with private firms to perform work. A private individual or organizations, the arranger, and government is the producer. This arrangement is called government vending. In this case, the consumer is the arranger.

## **3. Intergovernmental Agreement**

A government can hire or pay another government to supply a service. Counties sometimes contract with cities and pay the latter to maintain county roads within city limits. States contract with cities and counties to provide social services to families and individuals. Reassignment of service responsibilities between jurisdictions occurring to a significant

degree in an attempt to handle regional problems better and cope with rising cost. We refer to such institutional arrangements as intergovernmental agreements. One government is the producer, but another is the service arranger.

#### **4. Contracts**

Governments contract not only with other governments but also with private firms and nonprofit organizations for delivery of goods and services. In this arrangement the private organization is the producer and government is the arranger, which pays the producer. In a contract arrangement, government ideally is an articulator of democratically expressed demands for public goods and services, a skillful purchasing agent, and a sophisticated inspector of the goods and services that it purchases from the private sector.

#### **5. Franchises**

Franchising is another institutional structure used for providing services. An exclusive franchise is an award of monopoly privileges to a private firm to supply a particular service, usually with price regulation by a government agency. In franchise service, as in contract service, government is the arranger and a private organization is the producer of the service. However, the two can be distinguished by the means of payment to the producer. Government pays the producer for contract services, but the consumer pays the producer for franchise service. The franchise arrangement is particularly suitable for providing toll goods.

#### **6. Grants**

Toll goods and private goods whose consumption is to be encouraged can be subsidized and provided through two different structural arrangements: grants and vouchers. The grant may be in the form of money, tax exemption or other tax benefits, low-cost loans, or loan guarantees. The effect of such grants is to reduce the price of the particular goods for eligible consumers, who can then go into the marketplace and purchase for themselves from the subsidized producers more than they might otherwise consume. Under the grant arrangement the producer is a private firm, both the government and the consumer are involved as coarrangers. Usually both government and the consumer make payments to the producer.

## **7. Vouchers**

The voucher system is also designed to encourage the consumption of particular goods by a particular class of consumers. Unlike the grant system, which subsidized the producer and restricts the consumer's choice to the subsidized producers only, the voucher system subsidizes the consumer and permits the latter to exercise relatively free choice in the marketplace. The voucher has a certain monetary value. So, the producer takes the voucher, turns it into the specified government agency, and receives money for it. In voucher systems, the producer is a private firm, both government and consumer pay the producer. Whereas in the grant arrangement both government and the consumer select the producer, in the voucher arrangement the consumer alone makes the choice.

## **8. Market**

The market system is the most common of all service arrangements. It is used to provide most private and toll goods. The consumer arranges for service and selects the producer, which is a private firm. Government is not involved in the transaction in any significant way, although it may establish service standards. Market arrangements are widely used to supply such necessary goods and services.

## **9. Voluntary Service**

Charitable organizations, through their voluntary efforts, provide a host of human services to people. Other voluntary associations perform community services that are provided elsewhere by government agencies. For example, recreation programs, street cleaning protective patrol, and fire protection by neighborhood associations. In this arrangement, the voluntary mutual-aid association acts as service arranger and either produces the service directly, using its members or employees, or hires and pays a private firm to do the work.

## **10. Self-service**

The most basic delivery mode of all is self-help or self-service. Protection against fire and theft is obtained primarily by rudimentary self-service measures, such as extinguishing cigarettes and locking doors. The individual who brings his newspapers to recycling center, drives to work, or gives vocational guidance to his child is practicing self-service. The family

as a self-service unit is the original and most efficient. It provides a wide range of vital services to its members.

### **11. Arrangement of Goods and Services**

The ten organizational arrangements can be thought of as pure structures that can be employed either alone or in combination to provide a service. It is possible to make effective use in service delivery of multiple, hybrid, and partial arrangements. Multiple arrangements can be employed by a jurisdiction for a single service. In addition to multiple arrangements, the use for more than one arrangement to provide the same service in the same area, there are hybrid arrangements.

Partial arrangements are also widely employed. Services are usually comprised of a bundle of separate but coordinated activities, each of which could be supplied separately. Different arrangements could be used for different parts of the service. The result is a comprehensive service that may be part governmental, part contract, part voucher, and part self-service. The partitioning of the service can be carried out along either operational or functional lines.

Operational activities can be separated and handled by private contractors, even though the basic service is performed mostly by a public agency. This is a combination of arrangements to provide the overall service. Along functional lines, a government agency can own the capital facilities required for a service but contract out the service itself. Conversely, an agency can produce the service but rent privately owned buildings for its needs. Another approach is to contract only the management of an otherwise governmental service.

Moreover, there are three functional areas: ownership, management, and operations. These can be divided between the public and private sectors in eight different ways. By considering all the different elements of a typically complex public service, one may arrive at innovative ways to utilize the different arrangements for different parts of the service. The end result is a larger number of potential services producers and the creation of a competitive climate, a market for public services, that can lead to improved service performance.

## **C. THE FIRM AND PUBLIC ENTERPRISES**

In a capitalistic society, resources are owned and allocated by such nongovernmental organizations as firms, households, and markets. Resources owners increase productivity through cooperative specialization and this leads to the demand for economic organizations which facilitate cooperation. When a lumber mill employs a cabinetmaker, cooperation between specialist is achieved within a firm. When a cabinetmaker purchases wood from a lumberman, the cooperation takes place across markets or between firms.

### **1. Economic Organization**

An important problem appears in economic organizations. Whether the gains from specialization and cooperative production can better be obtained within an organization or across markets and the structure of the organization (Alchian and Demsetz 1972, p. 777). If a firm does not own all its inputs, the presumed power to manage and assign workers to various tasks is the same as an individual consumer's power to manage and assign his grocer to various tasks. A consumer can assign his grocer to the task of obtaining whatever the consumer can induce the grocer to provide at a price acceptable to both parties. That is precisely all that an employer can do with an employee.

The economic organization through which input owners cooperate will make better use of their comparative advantages to the extent that it facilitates the payment of rewards in accord with productivity. If rewards were random, and without regard to productive effort, no incentive for productive effort would be provided by the organization. Two key demands are placed on an economic organization: metering input productivity and payment of rewards.

Metering problems sometimes can be well resolved through the exchange of products across competitive markets, because in many situations markets yield a high correlation between rewards and productivity. Team production is production in which 1) several types of resources are used and 2) the product is not a sum of separable outputs of each cooperating resource. In team production, marginal products of cooperative team members are not so

directly related to rewards. What a team offers to the market can be taken as the marginal product of the team but not of the team members.

Market competition, in principle, could monitor some team production. Market competition among potential team members would determine team membership and individual rewards. Incumbent members will be constrained by threats of replacement by outsiders offering services for lower reward shares or offering greater rewards to the other members of the team. Monitoring cannot measure output performance, apportioning rewards, observing the input behavior of inputs as means of detecting or estimating their marginal productivity, and give assignments or instructions in what to do and how to do it.

Managing or examining the ways to which inputs are used in team production is a method of metering the marginal productivity of individual inputs to the team's output. The relationship of each team member to the owner of the firm is simply a "quid pro quo" contract. Each makes a purchase and sale. The employee "orders" the owner of the team to pay him money in the same sense that the employer directs the team member to perform certain functions.

Two necessary conditions exist for the emergence of the firm. It is possible to increase productivity through team-oriented production. It is economical to estimate marginal productivity by observing or specifying input behavior. Ordinary contracts facilitate efficient specialization according to comparative advantage, a special class of contracts among a group of joint inputs to a team production process is commonly used for team production. A central common party to a set of bilateral contracts facilitates efficient organization of the joint inputs in team production.

The term of the contracts forms the basis of the entity called the firm. Team productive activity is that in which a union, or joint use, of inputs yields a larger output than the sum of the products of the separately used inputs. This team production requires an assessment of marginal productivities if efficient production is to be achieved.

## **2. The Firm**

Restricted to those organizations or individuals which produce marketable output, then one definition of a firm could be any person or collection of people who turn inputs into outputs. This definition also means the exclusion of many forms of government activity as well (Sawyer 1979, p. 10). In economic theory we find that the allocation of factors of production between different uses is determined by the price mechanism. In other words, the costs of organizing within the firm will be equal either to the costs of organizing in another firm or to the costs involved in leaving the transaction to be "organized" by the price mechanism (Oliver 1991, p.30).

Businessmen will be constantly experimenting and controlling factors of production and more or less, in this way, equilibrium will be maintained. This is the position of equilibrium for static analysis. But it is clear that the dynamic factors are also of considerable importance, and an investigation of the effect changes have on the cost of organizing within the firm and on marketing costs must be made. This will generally enable one to explain why firms get larger and smaller. This moving equilibrium appears to have clarified the relationship between initiative or enterprise and management. Initiative means forecasting and operates through the price mechanism by the making of new contracts. Management proper merely reacts to price changes, and rearranges the factors of production under its control.

## **3. Market Economy**

There must be firms in a market economy. Consumers alone could not establish the market prices through their own decisions. Individuals come into a market each day prepared to perform productive services at some price. Among these individuals would be specialists in specific functions and specialists in co-ordination. For capital in the form of productive implements has to be provided in order that the workers can produce an "efficient" quantity of output (Malmgren 1961, p. 400). Owners of capital goods could offer the services of such goods, the market price mechanism would allocate resources and services to their most efficient uses.



Coase proposed an explanation as to why firms should arise in such markets. As explained by Oliver, Coase suggested that the distinguishing characteristic of the firm is the supersession of the price mechanism. The most obvious reason for this is that there are costs of using the price mechanism. Coase's view depends upon uncertainty about the current and future states of events. Because of uncertainty the competitive price mechanism in a market of individual producers and consumers breaks down. The lack of information about a range of events that firms have put together, long-term contracts, and regulated markets for clearly defined services can be developed leads to this uncertainty (Oliver 1961, p. 401). Taking this perspective we can say that there is a definite transaction cost in using the price mechanism; it is the costs of collecting information on the relevant sets of events.

A perfectly competitive static economy generally assumes that all buyers and sellers know all the relevant prices in the system in order that equilibrium be attained. There still remains the problem of the determination of the "correct" prices if the market is not initially at equilibrium. In the absence of universal omniscience, buyers and sellers would have to be allowed to explore the market for this correct price.

#### **4. Information and Expectation**

Multi-person and multi-process firms arise in a market economy for a number of reasons which are corollary to the existence of transaction, or information, cost. To begin with, they gain an advantage over the market in certain areas of production and sales by reducing or eliminating the cost of finding out relevant prices. As a result a number of long-term contracts are arranged. Operating rules of quite simple nature replace a more thorough analysis of every possible transaction which might arise in market-determined allocation of resources over the set of activities which make up the firm.

This stabilization of events extends into the market transactions which remain acting as an integrated market. Stabilization is characterized by the holding of inventories, buying and selling in a way which tends to reduce fluctuations and thus costs. The firm predicts the costs of production of its goods. Moreover, it will be better than the market could perform over its set of activities by eliminating the divergence of expectations which may arise when interdependent decisions are taken by independent decision-makers.

In relation to reaching equilibrium we may prefer to consider equilibrium in terms of the individual firm's plan. Equilibrium for the individual firm exists only for actions which make up a consistent plan. Any change in information would disrupt that equilibrium and create conditions for a new one. Equilibrium can exist only so long as the actions planned prove correct. If they prove incorrect, the change in planning data would require a rearrangement of the plan according to the new information if the plan were to be efficient. Everyone would have to base his expectations on the same set of events as everyone else, and come to the same conclusions, or plans would have to be quite independent with respect to their consequences.

### **5. Investment and Finance**

Most of these so-called theories of the firm are only concerned with the conversion of a service stream into a flow of output. The dominant theory, the neoclassical theory of the firm, ignores both investment and finance, modeling firms as purchasing the services of durable goods and labor in the perfect rental and labor markets. The neoclassical theory of production is satisfactory for some purposes, but it is not a general theory of firm behavior. The competitive firm invests in all types of assets, financing these procurement in various ways; this behavior has enormous effects on the firm's output decision.

A fundamentally sound theory of capitalistic production integrates firm investment and finance. The firm is simply an aggregation of assets, and maximizes its long-run profits by varying its asset and liability structures. Also, it must decide not only in which assets to invest, but also how to use the services generated by the real assets.

The important variables are the size, date, and risk of the cash flows generated by the assets. The firm must decide whether to finance its current and future operations by borrowing, new equity issues, or through internal funding. Production and money capital constraints are the subject of firm's choices. The production constraints on the firm are an enumeration of all the different output streams which can be obtained from given resources and include the ways these streams are affected by varying the use that is made of potential resources. The firm is assumed to be a perfect competitor in an uncertain environment.

## **6. Optimization**

Given the need for a more robust theory of the optimization of the firm, the work is motivated also by the pragmatic objective of developing sounder policies for efficient business behavior. What should the firm optimize? We need to consider what form of a maxim should the firm take. The optimization problem will depend on the owners of the firm.

In the general case this will involve the maximization of the value, what we shall call the economic value of the ownership investment in the firm (Vickers 1968, p.8). This in turn involves the maximization of the capitalized value and present discounted value of the income stream the business can be expected to generate.

The view implicitly is the economic value of the asset investment at work in the firm. Also, to be ascertained is whether the structure of income-generating assets to which investable funds have been committed is in some sense, an optimum structure. The investments that have been financed comprise, in some similar sense, an optimum structure of financing sources. Thus optimization objective will involve the optimization of the productive and operating structure of the firm. This will lead to the concept of "sequential decision-making" points, at which the enterprise structure is examined for its consistency.

## **7. Public Enterprise**

In any country, public enterprise (PE) has reached a certain degree of industrial and social development. Its development is due to a variety of motives, pressures, and purposes which differ from country to country, and from government to government. Practical needs of nation-wide development of a utility or commodity for which private investment capital is not available or sufficient, appears to be the predominant reason for the establishment of PEs (Hanson 1955, pp. 11-12).

Aharoni characterizes PEs as explained by Volsgang, as having three properties. The enterprise has to be publicly owned. It has to produce private goods, and it has to sell these goods at a price related to cost (Volsgang 1990, p. 2). PEs are traditionally active in areas that are loaded with externalities and other public goods aspects. Also, PEs are often purposefully located in particularly backward areas so they provide for infrastructure to

Many PEs produce under increasing returns to scale due to indivisible inputs which makes their production semi-public.

A particularly fertile field for PEs has been underdeveloped countries covering vast and relatively poor areas into readily accessible industrial resources. With limited resources, the State must invariably intervene to develop public utilities which are not attractive to private capital. The need for a basic national economic development in underdeveloped countries, and the satisfaction of urgent defense and strategic needs, are among the most widely accepted and frequent motives for establishing PEs. Beyond this area, the scope of PEs are the object of political, economic, and philosophical controversy. In fact, PEs have played an important, indeed an indispensable part in the development of all these countries.

There are approximately three main types of PEs. First, is administration by government department. As the tasks of modern government increased, whether the causes were defense needs, economic crises, or new social demands, government departments found themselves saddled with an increasing variety of enterprises of an essentially economic character. Obviously, neither the routine nor the training of the civil service was adapted to these new tasks which were often specialized and highly technical.

Second, is the joint stock company governed by company law but controlled by public authority as principal shareholder. The use of the commercial company as a form of PEs in which the State itself, or a public authority on behalf of the State, exercises control through the ownership of a majority of the shares. Sometimes, this control is reinforced by the reservation of special privileges in the bylaws of the company. This is the most wide-spread form of industrial PEs. The State has stepped into economic and industrial management, this may be as a result of pressures and emergencies rather than as a result of deliberate policy. The intervention of the State may have been the result of economic depression, defense needs, defends for the development of certain scarce but important, and costly natural resources.

Third, is the public corporation proper. It is based on the recognition of the participation of the State in economic enterprise. The characteristic features of public corporation are as follows: each public corporation is separately established by statute and

it is an individual. The public corporation is an independent corporation with separate legal personality. Its administration is in the hands of a governing board appointed by the government. The employees are not civil servants.

### **8. The Role of PEs**

As a publicly owned corporation that produce private goods, the government retains some authority to intervene directly in the delegated production arrangements and effect major policy changes when it is deemed necessary to do so (Lawson 1994, p.283). Such enterprises, have multiple objectives, answer to several different ministries, and operate under peculiar constraints. PEs concentrates on the motives for state ownership boil down to ideological and economic. For socialists it may be important in order to influence or control the overall direction of the economy. The economic reasons revolve around the issues of natural monopoly, the need for economic planning, the advantages for stabilization policy direct industrial intervention, and the redistribution of power, income, or wealth.

On the other side, it is sometimes recommended as a device to protect the consumer from the excesses of monopoly power. Wealth redistribution depends on the terms and conditions attached to ownership change, while income redistribution is influenced by the firm's prices and wages. In advanced market economies, PEs role is around the exploitation of their monopoly power, either natural or created by state license, to raise revenue for the state. Also, an equally prominent role has been the promotion of industrial development.

In the context of developing economies, PEs may have a role in galvanizing domestic manufacturing activity, providing infra-structural services, or winning and channeling foreign economic assistance. This is because the capital markets are not always fully developed, and risk-bearing ability or willingness by private entrepreneurs is deemed inadequate for national needs. But, even though there is an economic argument, that the output has some public goods' characteristic, all that this may indicate is the need for public subsidy to prevent under-provision (Baumol 1984, p.14). The search for appropriate institutional forms, the enforcement of efficiency and the stimulation of innovation are the key desirable properties.

There are normative reasons for the existence of PEs in certain ideological arguments, and in some cost-minimizing solutions where the unfettered private solution is thought to be undesirable, or in the case of some developing economies where the solution is unattainable. In countries where the public finance and social welfare systems are underdeveloped, then PEs pricing policies can be an effective way of achieving redistribution. But, this may simply be a means to effect a less visible income and wealth redistribution that could be obtained by direct transfer (Vogelsang 1990, p. 17). Direct redistribution is more precise than redistribution by regulation.

### **9. Modeling and Consequences**

Among property-rights theorists, De Alessi stresses that the public at large cannot specialize in the firm's internal activity. So, the public has only weak incentives to check on PEs performance. He assumes that the managers derive utility from being able to control resources and this provides them with an incentive to increase their expenditures. The barriers to growth of managerial discretion are substantially lower, especially when the organization produces non-marketable outputs (Lawson 1994, p. 287). By increasing the resources under his provision, a bureaucrat will generate an increase in his marginal product and usually in his salary. This can be achieved by using unrealistically low discount rates to justify a relatively unproductive investment project.

Shapiro models the activities of the bureau responsible for the projects by assuming that management wishes to maximize its salary by maximizing the organization budget through lobbying the legislature. The legislature approves the budget, but it and the public are more interested in the benefits the agency can deliver than in the allocative efficiency of the selected projects or the technical efficiency with which they are performed. Budgets are typically treated as either exogenous or mechanically derived from congressional demand functions (Lindsay 1976, p.1063). Because of the political costs of raising taxes, the shadow price of government funds is high, which makes increasing PEs profits an "attractive objective" (Vogelsang 1990, p.55). Profit maximization is an adequate specification of the goal because they lay particular stress on organizational processes.

The motivation for such inter-authority payments is often damaging allocative efficiency. Goal formation should have a central role in PEs behavior. Because managers cannot directly own property rights in PEs, it is argued that they have only weak incentives to take a long-run view of its development. Also, government intervention reduces rewards and raises costs to the PEs.

If managerial salaries are linked to the size of the firm's budget, then inadequate monitoring can encourage increased expenditure. The limited monitoring ability of the political authorities can produce unintended consequences (Lindsay 1976, p. 1064). Congress can only monitor certain aspects or output, so the quality of other aspects of the product will deteriorate.

Inadequate monitoring and non-profit objectives suggests that PEs are less likely to introduce cost-saving innovations and achieve cost minimizing. Because capital is provided at subsidized rates PEs are likely to have too capital intensive of a production technique. More generally, production subsidies Vogelsang points out may cause rent-seeking. In addition, lack of market competition and multiplicity of objective are the predominant sources of PEs inefficiency.

#### **D. PRIVATIZATION AND FORMS OF PRIVATIZATION**

In seven of the ten arrangements the private sector is the producer: contract, grant, voucher, franchise, market, voluntary, and self-service. These can be considered private-sector arrangements. The arrangement in hierarchical order are as follows: market, voluntary, self-service, franchise, voucher, grant, contract, government vending, intergovernmental agreement, and governmental. But, the privatization is a dynamic concept and means changing from an arrangement with high government involvement to one with less (Savas 1987, p. 88). Privatization means changing to an arrangement where the private sector plays a more dominant role.

## 1. The Theory

Property-rights arrangements provide the key to understanding the behavior of private and public employees and the performance of private and public enterprises. When private enterprises produce goods and services that consumers demand, at costs that are lower than market prices, profits are generated. Alternatively, if losses are realized, the value of private assets declines. Hence, the owners of private firms not only appropriate the gains but also bear the costs that result from the way in which private property is used.

Private owners face significant incentives that make it desirable to monitor the behavior of private-enterprise managers and employees, so that they will supply what consumers demand in a cost effective way (Hanke 1985, p. 102). Consequently, private managers and employees find it difficult to engage in shirking behavior or behavior that is inconsistent with maximizing the present value of the private enterprise. Private property puts in place incentives that tend to generate efficient performances.

By way of contrast, PEs are not owned by individuals who have residual claim on the assets of the organizations. The nominal owners of PEs, the "taxpayer-owner" cannot buy and sell public enterprise assets. Consequently, they do not have strong incentives to monitor the behavior of public managers and employees. Moreover, public managers and employees allocate resources that do not belong to them. They do not bear the costs of their decisions, nor do they appropriate the gains from efficient behavior. Since the nominal owners of PEs have little incentive to monitor public managers and employees, the cost of shirking to a public bureaucrat is low. Consequently, public managers and employees would probably engage in shirking activity and acquisition of various perquisites that increase production cost.

Private owners bear the costs and capture the benefits associated with implementing their plans. PEs also plan, but their plans are fundamentally different from private plans. This is because they are developed by bureaucrats. Bureaucrats who neither bear the cost of their mistakes nor legally capture the benefits generated by foresight. Hence, from a theoretical point of view, private and public managers and employees can be expected to



behave in different ways and, as a result, private firms will be more efficient than public firms.

Another axiom of privatization is related to the management of the program. It is important that such programs be managed as effectively as possible. One difficulty with doing this is often little management continuity from one program to the next. As a consequence, management mistakes, in the form of excessive agency costs, are unfortunately repeated and economic and human resources are misallocated (Hogan 1994, p.15). Privatization promise stems from its ability to deal with agency problems by supplying management linkages missing from other approaches. These linkages allow administrators to reach program objectives efficiently and expeditiously.

Privatization opportunities would allow firms to compete more effectively worldwide and eliminate costly subsidies to money losing PEs. Privatization provides a much-needed foundation for economic stability and to initiate a market economy. Public firms' costs are often greater than they are in private firms.

## **2. Privatization Form**

Aside from its fundamental role, government is engaged in planning, paying for, and producing various goods and services. To privatize means to rely more on the private institutions of society and less on government to satisfy people's needs. More narrowly, privatization is the act of increasing the role of the private sector, or decreasing the role of government, in an activity or in the ownership of assets.

Government activity or PEs can be privatized by three broad strategies: divestment, delegation, and displacement (Savas 1990, p.345). First divestment, divestment means shedding an enterprise or asset. This requires a direct, positive act by government. The enterprise or asset is either sold or given away as an ongoing business, or an enterprise may be liquidated. Divestment by sale can be carried out in five ways: 1) selling the enterprise to a single buyer; 2) selling to the public by issuing and selling shares; 3) selling the enterprise to the managers; 4) selling to the employees; and 5) selling the enterprise to its users or its customers. Divestment by donation does not require sale of an enterprise; the latter could be given away, for example to employees, to users, or to customer. Divestment

liquidation can be carried out by liquidating a poorly performing enterprise, if the prospects are bleak for achieving profitability.

Secondly, delegation requires a continuing active role for government. Government delegates to the private sector part or all of the activity of producing goods or services, but government retains the responsibility to oversee the result. Delegation is carried out by contract, franchise, grant, voucher, or mandate. Finally, displacement is a somewhat more passive process that leads to government being displaced more or less gradually by the private sector. Displacement occurs by default, by withdrawal, and by deregulation.

### **3. Method of Privatization**

Privatization is a field that does not permit dogmatic treatment. The choice of privatization techniques is generally a function of the government's objectives, the PEs condition and its sector of activity, and the country characteristic (Vuylsteke 1988, p.3). Obviously, the profitability of PEs are one of the determinants of how easy or how difficult its sale will be. Privatization potential is not limited to a strong performing PEs. Where widespread share ownership is desired, a public offering should be the preferred method; but the near absence of financial markets and the concentration of domestic private capital and entrepreneurial expertise may not permit a public offering.

When privatizing public utilities, regulatory aspects will be paramount. When setting the objectives of a privatization program, it may be necessary to allow for trade-off, based on the feasibility of techniques relative to a given set of objectives. The more difficult issues are commonly the financial condition, excessive liabilities, and financial markets. Employment effects are commonly considered a major constraint to privatization as well. Every privatization undertaking needs to be carefully planned and managed.

The most commonly used methods of privatization are:

- Public Offering of Share
- Public Sale of Shares
- New Private Investment in PEs
- Sale of Government or PEs Assets
- Reorganization (Or Break-up) into Component Parts

- Management / Employee Buy Out
- Lease and Management Contract

Several of these methods can bring about total divestiture or denationalization or can be implemented partially or gradually. The choice of a particular method will be dictated by the objectives being sought and other factors.

### III ECONOMIC PERFORMANCE

#### A. CRISIS AND REFORM

##### 1. Political and Economy

The political collapse that accompanied the state of economic chaos in Indonesia in the 1960s was a major crisis. Runaway inflation had peaked at 595 percent in 1965. A myriad of microeconomic distortions had created serious economic disarray. The extent of macroeconomic imbalance had also made it impossible for the most productive economic sectors to grow. With the collapse of old regime, new opportunity was opened. The new government replaced a policy of easy money with a policy of fiscal balance (Williamson 1994, p. 386). This bold change was initiated by a group of economists, who later became known as the economic technocrats.<sup>1</sup> The outcomes of the reforms were quite dramatic: the inflation rate dropped to less than 115 percent in 1967, 17 percent in 1969, and 19 percent in 1973. Output in the agricultural and the manufacturing sector increased, gross domestic product (GDP) growth revived, reaching 9.2 percent in 1970, and 14 percent in 1973.

The crisis of the 1980s was propelled by the worldwide economic recession of 1982-1983 and by a plunge in oil prices which affected the Indonesian economy. The government responded immediately and fairly forcefully to the external shock. A series of measures within a wide-ranging stabilization and structural adjustment program were introduced. Part of the program was reflected by the implementation of a balanced budget policy, such as budget cuts and postponing major industrial projects. On the revenue side, the government moved to non-oil revenues through a major tax reform.

With the fall of oil prices, the capacity of the state to provide the funds for its industrial strategy has been seriously eroded. Pressures to move Indonesia's emphasis from import-substitution industrialization to export-oriented industrialization have been strengthened (Robison 1987, p.16.). This policy implies a greater integration with the new

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<sup>1</sup> This group was labeled the "Berkeley mafia" because most of its members had been educated at University of Berkeley.

international division of labor. The policy successes will be determined by several factors. For example, factors such as commodity prices and the capacity of the state to resolve fiscal crises, political struggle between international corporate capital and financial institutions, struggle between liberal reformist elements of the domestic technocracy on one hand and the bureaucratic and corporate forces whose interests are vested in the current industrial strategy on the other hand. Moreover, a value-added tax was introduced in 1985 in the manufacturing, construction sectors, and fuel oils. An additional tax was also applied to luxury goods sold in the domestic markets. These tax reforms dramatically increased the shares of oil and non-oil receipts in the budget. In the following years, income and land tax revenues increased resulting in a dramatic jump in total non-oil revenues of around 30 percent in the period from 1987 to 1990.

Reform was also made in monetary policy. During the oil boom, monetary policy had been based primarily on two mechanisms: credit ceilings and interest rate controls of state banks. The plunge in oil prices led to a shortfall in government revenues and a balance of payment deficits. This forced the government to promulgate monetary and financial reforms. These reforms were aimed at dismantling the old system of monetary control, and replacing it with a more indirect approach based on reserve management through open market operations. Meanwhile the government took a strong stance on maintaining the stability of the exchange rates and domestic prices. This prudence has paid off with inflation remaining under control and in the single digits. This has resulted in a stable real exchange rate and greater competitiveness (Williamson 1994, p. 391). The GDP rose on average by 5.1 percent per year during 1983-86 and 6.4 percent 1986-90.

The policy direction proposed to reform the economy was using pro market mechanisms. This recommendation came from a single group of people, namely the economic technocrats. Their approach is pragmatic, professionally based, and is little influenced by party politics and ideology. The concrete outcomes of their strategy is a rising standard of living, sustained rapid growth, low inflation, and the enhancement of infrastructure throughout the country. Fortunately, this economic team has received the full support of the president. This support is a factor of utmost importance. The blessing of the

president has strengthened the implementation of some difficult decisions. For example, a courageous decision to devalue the currency in 1983 and 1986 originally encountered great resistance among some interest groups, but the devaluations were implemented anyway. The consequences were positive, as export growth accelerated while inflation was kept at a single-digit level.

The responses to this crisis from Indonesia came just at the time when the crisis was becoming apparent. To balance the budget, the World Bank argued for the removal of extensive fuel and food subsidies and the immediate development of domestic revenue sources to replace declining oil taxes. The World Bank also called for a reduction in state investment in large resource and industrial projects. This recommendation was to correct what the World Bank regarded as an irrational pattern of investment and an inappropriate industrial strategy. According to the principles of comparative advantage, the World Bank officials urged that the Indonesian economy be allowed to respond to the free operation of the international division of labor. Removal of state subsidies and protections would make way for the replacement of inefficient and costly industries. (Robison 1987, pp.29-30)

## **2. Industrial Strategy**

The consolidation of the power of the state and government officials was through the process of industrialization and the emergence of major domestic corporate groups that were built around oil revenues. Consequently, the collapse of oil prices posed a fundamental threat to the fabric of power and government policies in Indonesia. At the heart of the upheaval has been the question of economic strategy and industrial policy.

Meanwhile, there has been a remarkable continuity in certain key aspects of Indonesian economic policy. Two important ideological factors have underpinned this continuity. First, it has been generally accepted by successive governments that the state has a legitimate economic role and that market forces must be tempered by social objectives. Second, it has also been accepted that foreign ownership and control of the Indonesian economy be restrained, that the nurturing of domestic investment must be a priority and that a significant degree of national autonomy is the basic objective in shaping the structure of the economy (Robison 1987, p. 17). This element of economic nationalism has had important

implications for industrial policy, because these policies have meant that the drive to establish capital and intermediate goods sectors has been a central investment objective.

At the ideological level, nationalism and social justice are powerful legacies of the anti-colonial struggle, the vision of an autonomous, powerful, industrial Indonesia has been a driving force behind long-term economic strategy. Economic strategy has been meshed with the interests of the dominant political strata: the politico-bureaucrats who exercise hegemony over the state apparatus. State power to intervene in and to regulate the economy has been subject to appropriation by politico-bureaucrats not only to shape the pattern of vast state investments but also to control the allocation of state concessions for the private sector (Glassburner 1971, pp.80-81).

This political control over the economy has provided the sources of revenues, patronage and power that underpins the dominance of state officials in both socio-economic and political levels. Policies of economic nationalism and state intervention have provided the basis for the emergence of major corporate conglomerates, both public and private. State corporations as well as major private groups have been built upon monopoly positions and preferential access to licenses, supply and credit, all derived from the intervention of the state in the economy. Combined with extensive protection of these domestic groups through tariffs and restrictions on foreign investment in certain sectors of the economy, economic nationalism have been essential to the emerging domestic capitalist class.

Policies of state-led import-substitution industrialization had become integral to the interests of the alliance of economic and politico-bureaucratic power. The Department of Industry is now able to exert more influence in this area and has began a concerted move towards industrial deepening and the creation of backwards and forwards linkages in manufacture that are designed to establish self generating, mutually reinforcing, sectoral growth. This has involved heavy state investment in steel and other metal industries, petro-chemicals, oil refining and liquid natural gas production, fertilizers, machine tool production and the provision of infrastructure (Gray, 1982).

### 3. Progress on Development

Since the new government, Indonesia has made great strides, achieving an average GDP growth of almost 7 percent per annum. This growth performance ranks among the ten fastest in the world. Indonesia's per capita income reached \$ 650 in 1992 and \$ 905 in 1994<sup>2</sup>, implying a substantial improvement in living standards. But, Indonesia is still classified as a low income country. Consistent emphasis on maintaining economic stability, marked by the willingness to make hard decisions in times of both boom and bust, provided a solid foundation for sustained growth.

Prudence was exercised during the years of the oil boom, and the oil windfalls were spread over time and across sectors in a manner that avoided the erosion of the non-oil sectors that has plagued most other oil-exporting countries. The development strategy emphasized channeling oil revenues into raising agricultural output and developing physical and social infrastructure. The development of infrastructure strengthened the foundations for future growth.

A series of external shocks to the economy have affected these development and sharply reduced exports and fiscal revenues. This has created sizable external and domestic financial imbalances, and raised the cost of external debt service. The government responded promptly and effectively by embarking on adjustment program: restoring macroeconomic stability and monetary restraint and establishing a more diversified and efficient productive base through structural reforms and reduced the dependence on oil. The strategy to develop the non-oil economy has two main thrusts: promotion of the private sector and encouragement of a more outward-oriented economic structure. The structural reforms were developed within a comprehensive medium-term framework that fostered credibility through consistent implementation (World Bank 1994, p. 3). This strategy was successful in stabilizing the economy, maintaining growth and transforming the structure of production.

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<sup>2</sup> According to *The Far East and Australasia 1996*, 27th edition.



Macroeconomic management also substantially reduced the current account and fiscal deficit. Prudence in external borrowing allowed Indonesia to service its debt without requiring any rescheduling. Supported by prompt macroeconomic stabilization measures and structural reforms that has spurred competition and enlarged the opportunities for growth, the economy rebounded quickly from effects of these shocks. The major force driving economic recovery was the private sector, as private investment has responded vigorously to the policies of deregulation. The private sector contributed over 70 percent of the total gross domestic product (GDP) growth during the years of 1983-1991.

A strong surge in private investment, responding to the incentive and regulatory reform, combined with an easing of monetary policy, has led to the emergence of excess demand pressures. The government responded by tightening monetary and fiscal policies and restraining public and publicly external borrowing, which helped dampen the demand pressures. At the same time, the government continued to build on earlier reforms in trade policy and investment and industrial regulations.

Moreover, Indonesia in reduction of poverty is attributable to several elements of its development strategy: substantial investment in economic and social infrastructure that supported sustained, broad-based growth; strong emphasis on improving productivity in agriculture, the source of livelihood for the majority of the population and the overwhelming bulk of the rural poor; structural reforms that induced a shift from inward-oriented, capital-intensive activities toward export-oriented, labor-intensive; and cushioning of the impact of adjustment on expenditure programs beneficial to the poor. Evidence of the distribution of income, personal and regional, is more limited than evidence on poverty, but there has been a gradual reduction of disparities in income. (World Bank 1994, p.5)

## **B. SUSTAINING DEVELOPMENT**

The past successes have enabled the government to build on a strong economic foundation. At the same time, there needs to be a clear recognition of the formidable challenges for sustaining development that lie ahead. Future challenges stem both from the fact that, despite past progress, Indonesia remains a low income country, with a sizable

segment of its population still living in absolute poverty. The task is to sustain development and maintain a robust pace of economic growth to improve the living standards and provide gainful employment to the rapidly expanding labor force, and promoting equity by reducing poverty and broadening participation in development.

### **1. Growth With Stability**

Sustained robust growth is central to achieving Indonesia's development objectives. To employ the labor force, which increases annually, non oil GDP must grow. Sustaining this rate of growth is a major challenge. A stable macroeconomic foundation is a necessary condition for sustained economic growth (World Bank 1994, p.11). In maintaining a stable macroeconomic environment, the primary challenge stems from Indonesia's large external debt. In absolute terms, Indonesia's external debt is now one of the largest in the developing world. The debt burden is heavy and it limits Indonesia's policy flexibility and raises its vulnerability to external shocks. A central goal of macroeconomic management is to reduce this burden gradually to levels that are more sustainable in the medium to long term.

Sustaining robust non-oil export growth is the key to reducing the external deficit. To achieve and sustain a non-oil GDP growth, the investment rate will need to rise. Reconciling the higher investment rate with the need to reduce the current account deficit will require an increase in the national saving rate. This underscores the need to intensify domestic resource mobilization. One challenge will be to manage a smooth transition to an increased role of private capital in external financing and to diversify the sources and types of financing. Also, to promote greater foreign direct investment that will reduce the need for debt-creating flows, and providing new technologies and market access.

Furthermore, policies for growth must adapt to the evolving nature of the growth process. Success in sustaining the momentum of growth will depend greatly on how effectively Indonesia manages some important dimensions of this evolution. This will include both the fundamental qualitative shifts in the growth process and major structural transformations in the economy. This comprises an increasingly important role of improvements in efficiency and productivity as a source of growth and a transition from quantity to quality in the production of goods and services.

In the increasingly tougher international business climate, marked by globalization and keener competition, raising efficiency and productivity would be the key to sustaining the dynamism of non-oil exports. That will remain the premium engine of Indonesia's economic growth and diversification. Besides exports, efficiency and productivity improvements hold the key to the role the domestic market will play in future growth. The critical need is to foster increased competition, not only by opening the economy further to competition from abroad, but also by intensifying efforts to remove barriers to competition within the domestic economy. More broadly, raising efficiency and productivity will be essential to realizing Indonesia's growth objectives within the limits of available resources.

A transition from quantity to quality in the production of goods and services is closely related to raising efficiency and productivity. In the public sector, this implies a shift of focus from expanding services to improving their quality. In private sector, improving the quality of goods, and the developing new products, will become increasingly important sources of market growth. In addition, to be the dominant provider of private goods and services, the private sector is expected to play an increased role in the provision of public services that may be provided within a competitive framework.

## **2. Equity Through Wider Participation**

The promotion of an equitable pattern of economic growth has been a major goal of the Government. In pursuing this goal, Indonesia will face three related requirements. There will be a continuing effort to reduce poverty in the long run, ensuring widespread regional participation in development, and promoting broad-based private sector growth. Progress in reducing poverty over the past two decades has been impressive, but about 27 million people, 15 percent of the population, remain below the poverty line (World Bank 1994, p. 14).

The first thrust of a poverty reduction strategy is the achievement of sustained economic growth. A review of evidence across developing countries suggests that economic growth is a major factor in the reduction of poverty. Economies with sustained economic growth and increased efficiency of resources use have generally experienced significant reductions in poverty (World Bank 1990, p.35). Growth and poverty reduction in Indonesia

are largely complementary, because of the flexible nature of Indonesia's labor markets. The continuation of macroeconomic policies aimed at achieving a sustainable recovery in growth, while maintaining stability will be an important prerequisite for further reductions in poverty. Achieving a more rapid rate of economic growth could have a dramatic effect on the incidence of absolute poverty.

During the 1990s, the principal sources of growth will be non-oil exports, especially manufactured exports and non-rice agricultural production. The manufacturing sector will continue to be an important source of economic growth and employment generation over the mid-term. The most promising route for employment expansion in the manufacturing sector is to enhance profitability of the export industries, since these industries are relatively labor intensive and have the best prospects for market growth. This requires an appropriate framework to boost manufactured exports. The key elements of this framework is the maintenance of a competitive exchange rate and continued progress on trade and industrial sector reforms, in order to reduce the domestic cost of production.

The agriculture sector will continue to play a critical role in providing better income opportunities to farmers, and supporting the development of rural off-farm employment by stimulating production of non-rice crops, smallholder tree crops and non-food farm activities. More rapid and efficient growth in agriculture and manufacturing will also spur growth in the services sector. Higher growth is likely to lead to improved earnings for workers currently engaged in low-wage activities, as well as generate additional productive employment opportunities in the agriculture sector. (World Bank 1990, pp. 36-37)

An important fact is that most employment in Indonesia has been and will presumably continue to be provided by private sector enterprises. Government actions directly and indirectly influencing the level and pattern of labor utilization by private employers and is of greatest importance in determining future employment and earnings prospects (World Bank 1980, p. 99). Employment growth in large and medium scale enterprises has been low even though it has probably accounted for the major share of the increment in non-agricultural output. An industrialization strategy that gives greater emphasis to the more labor intensive light manufacturing industries would offer greater opportunities for avoiding

the inefficiencies and inequities. In addition, a less concentrated process of industrial development is conducive to greater dispersion in the location of industry and would reduce the direct and indirect cost of shifting labor to a few primary centers of economic growth.

### **C. GROWTH CHALLENGE**

Many external constraints operated on developing countries in the 1980s and 1990s. Economic shocks, an expanding conditionality norm, growing bilateralism, and changes in the multilateral system pressed the developing countries toward greater integration with the world economy (Haggard 1995, p.45). This focus on international constraints is partly justified by the fact that the reformist trend among developing countries is worldwide. However, varied international pressures affect different developing countries in different ways.

Recently, the term globalization has become popular and overlaps significantly with the notions of convergence and interdependence (Jones 1995, p.93). Globalization means the hegemony of transnational capitalism in general, and the institutional primacy of the transnational corporation, in particular. To others, it means the general progress of the internationalization of finance, production and economic transactions, the capacities of governments for effective action. Furthermore, the significance of globalization is seen to lie in the standardization of production technologies and capabilities, world wide, and the increasing exposure of all states to a common set of practical problems and competitive economic pressures.

Indonesia's domestic policy will continue to be directed towards optimizing the economy's capacity to benefit from a favorable external environment, allowing continued strong growth without an acceleration of inflation. Much of this growth will be generated by increased exports. However, high imports of both consumption and investment goods associated with the strong growth in domestic demand will result in larger current account deficits. To address these problems, the government is tightening monetary policy in addition to maintaining fiscal restraint. Also, the government intends to implement further

measures to liberalize the economy, to reduce inefficiency and business costs, and to increase labor productivity (WIS 1995).

An economic expansion will be fueled by an increase in domestic demand and by higher investment activity. An emerging consumer class and a need for infrastructure development will provide a continuing supply of business and investment opportunities. Major challenges facing Indonesia are accelerating inflation, a widening current account deficit, and the erosion of Indonesia competitiveness in the labor-intensive export sectors. Strong domestic demand is putting upward pressure on prices and import demand is widening the current account deficit. Moreover, the country is plagued by crucial infrastructure constraints that could severely obstruct long term growth. Two and a half million jobs a year need to be created to accommodate school graduates entering the workforce. The economy must also continue to grow at about 7 percent per year. In this respect the country's ability to lure foreign investment away from competitors in Asia and elsewhere, and boost its export capabilities, will be crucial. Also, the country's external debt is not going down.

On the other hand, with an emerging consumer sector and a need for further infrastructure and industrial development, Indonesia provides solid business opportunities and a climate conducive to foreign investment. Local corporations will face higher borrowing costs because of higher interest rates engineered by a tight monetary policy. Corporation with solid reputations will increasingly seek cheaper financing in the capital markets or through offshore borrowing in response to higher local interest rates and tighter credit conditions.

Based on the generally favorable external trading conditions and domestic policy regime envisaged for the next five years, an annual average growth rate of 7.2 percent is forecast for the 1995-2000 period (EIU 1996). Growth is currently fueled by private consumption and investment. This rapid expansion of domestic demand is pushing up import growth, with the result that the external sector is providing to be a significant drag on growth. But, growth will be driven primarily by non-oil exports, which are expected to

accelerate in line with the rapid growth in world trade, and an increasing liberalization of the trading environment in the Asia-Pacific region in particular.

## **1. External Influence**

Recent history has been characterized by substantial variation in the types and intensities of shocks affecting the global economy and individual national economies. During periods in which these shocks have been large and created major changes in macroeconomic conditions, government officials have been confronted with uncertainties about the appropriate adjustments in their stabilization policies. Yet if the shocks have pronounced cross-border consequences and seem to threaten a crisis condition, governments also have a sharply increased incentive to try to manage the crisis (Bryant 1995, p.106). The many types of cross-border spillovers have gradually increased in intensity. In turn these increases are interdependent and this has reduced the effects of an individual nation's policy instruments on national variables relative to the effects on the variables in other countries.

### ***a. International Economy***

During 1993, the world economy grew only about 2 percent, the continuation of a slow recovery from the bottom of the most recent downturn in 1991. Low growth in the developed industrial economies and continued economic decline in the former Soviet Union and in parts of Eastern Europe held back the world economy. In the United States and most of the other industrialized countries, the process of industrial restructuring is continuing, adding to unemployment, hurting consumer confidence, and placing added pressure on government budgets (Jelacic 1994, p.9).

On the other hand, most of the world's developing areas continue to show economic strength. The International Monetary Fund (IMF) found that developing country output accounts for approximately 35 percent of the total world production. This estimate highlights the growing role of the East Asian economies, particularly the Chinese economic zone (China, Taiwan, and Hong Kong), in establishing a new "fourth pole" for sustaining world growth.

The segments that comprise the world economy - the flows of money and information on the one hand, and investment on the other hand - are rapidly merging into one

transaction stream. This flow increasingly represents different dimensions of cross-border alliances, the strongest integrating force of the world economy. Today's money flows are vastly larger than traditional portfolio investments made for the sake of short-term income from dividends and interest. Portfolio money flows were once the stabilizers of the international economy, flowing from countries of low short-term returns to countries of higher short-term returns, thus maintaining an equilibrium (Drucker 1994, pp. 99-100).

In structural and institutional trade decisions, markets and knowledge are important. Labor cost, capital cost, and foreign exchange rates are restraints rather than determinants. Traditional direct investment abroad to start or acquire businesses continues to grow, and the action is rapidly shifting to alliances such as joint ventures, partnerships, knowledge agreements, and outsourcing arrangement. Alliances, formal and informal, are becoming the dominant form of economic integration in the world economy. For developed economies, distinction between the domestic and international economy has ceased to be a reality, however much political, cultural or psychological strength remains in the idea. Lesson of the last 40 years is that increased participation in the world economy has become the key to domestic economic growth and prosperity. There has been a close correlation between a country's domestic economic performance and its participation in the world economy (Drucker 1994, p. 104).

As the world economy moves forward, manufactures are continuing to improve their competitiveness in the global economy, according to Steven M. Hronec, worldwide director of Arthur Andersen's manufacturing industry practice: (PRNewswire 1995)

For continued success in global marketplace, manufacturers will need to focus on innovative alliances, as well as new approaches to operations improvements and cost management, to close the profitability and productivity gaps between themselves and their competitors inside and outside.

Successful manufacturers will be those that use the strategies that cost-effectively meet customers' needs. Prosperous manufacturers will result because of continuous improvements in efficiency and productivity on the shop floor and by using new approaches to operations



management, with customers expecting high-quality products and attentive service. They also must continue to streamline product development, to be flexible, and customer-focused. Rapid technology changes will continue to make it easier to anticipate and meet customer needs.

***b. Regional Environment***

The Asia Pacific regions remains the fastest growing region in the world in this past year despite significance fluctuations in global financial markets. The most significant reasons for the fluctuations in the economies of the region are, among other events, shifting capital flows and rapidly moving exchange rates. Recent economic developments and the policies adopted have noted the increasing importance of growing interdependence of countries economies. Attaining free and open trade and investment has increased the exposure of their economies to market forces from the global financial marketplace. A number of significant benefits have accrued, increases the importance of sound, consistent, and sustainable macroeconomic policy in maintaining the dynamism of the region.

Global capital flows have grown substantially over the past years. With the growth of capital flows, and the increased reliance of all economies on them, has come increasing vulnerability to rapid shifts in the volume and direction of such flows. It is often difficult for authorities to determine in advance whether capital inflows are driven by short-term speculative motives or by longer-term intentions (U.S. Department of State 1995). Another factor is the importance of infrastructure development in the region to sustain non-inflationary growth toward the 21st century. From a western business point of view, Asia is a very good place to grow, especially for businesses that deal with infrastructure - energy, transportation, and communications. The developing countries overall are going to need enormous improvements in infrastructure if they are to sustain their current growth rates (Seidenberg 1996, p.363). Domestic and external private resources will increase their role to meet the need to invest in physical infrastructure. As the role of private financing in infrastructure development increased, a clear need for coordination of public and private resources is essential.

*c. Association of South East Asian Nations (ASEAN)*

During the decades of the 1970s and 1980s, the Asian newly industrializing economies (NIEs) of Hong Kong, Singapore, South Korea, and Taiwan have achieved phenomenal growth. By the second half of the 1980s, however, their growth rates began to decelerate owing to a number of adverse factors such as strengthening currencies and rising labor cost. On the other hand, expansion among 4 largest ASEAN economies of Malaysia, Philippines, Thailand, and Indonesia had gained considerable momentum. Since 1989, the average growth rate of the ASEAN has surpassed that of Asian NIEs, and the former are likely to maintain the lead into the 1990s.

There are four recently emerged trends that have accounted for the economic acceleration in this region (Wu 1991, p. 103).

First, is the emergence of Japan and the Asian NIEs as the leading capital and technology exporters to Southeast Asia. Direct investment from the five countries for the ASEAN nations registered an average annual growth rate of 103 percent. Uninterrupted capital infusion from Northeast Asia will help to upgrade the manufacturing capability of the ASEAN countries.

Second, along with rising intra-Asian investments is the rapid expansion of intra-Asian trade. To a great extent, the substantial increase in intra-Asian trade is a direct consequence of the emerging pattern of intra-Asian capital flows that are bringing about a higher level of division of labor among the Asian-Pacific economies.

Third, is the increasing diversification and sophistication of the ASEAN economies. Spurred by rising intra-Asian investments and trade, the ASEAN Four are embarking on a fundamental shift from their traditional dependence on primary commodities to manufacturing and services.

Finally, another propitious development is the ASEAN governments' increasing commitments toward the deregulation, liberalization, and privatization of their economies and financial markets. While the pace and extent of deregulation and liberalization differ from one ASEAN country to another, the various measures will in all likelihood help to

mobilize local resources, galvanize private-sector initiatives, enhance competition and improve overall economic efficiency.

It is not simply the population, land, and natural resources that give South East Asia its promise of long-term economic potential. Fueling their economic vitality is the convergence of substantial human and natural resources, geographic location, and growth-oriented governmental policies (Gong 1994, p.5). The ASEAN Free Trade Area (AFTA), established in 1993, is ASEAN's current vehicle for regional economic cooperation. AFTA is aimed at expanding intra-ASEAN trade in manufactured goods and creating an integrated market of its 330 million people with a combined GDP of \$ 293 billion, which is growing at 7 percent a year.

## **2. Internal Condition**

The economic expansion that will be fueled by an increase in domestic demand and by higher investment activity, an emerging consumer class and a need for infrastructure development will provide a continuing supply of business and investment opportunities. Major challenges facing Indonesia are accelerating inflation, a widening current account deficit, and an erosion in Indonesian competitiveness in the labor-intensive export sectors. Strong domestic demand is putting upward pressure on prices and import demand is widening the current account deficit. Moreover, the country is plagued by crucial infrastructure constraints that may severely obstruct long term growth. Two and a half million jobs a year must be created. The economy must also continue to grow at about 7 percent per year. The country's ability to lure foreign investment away from competitors in Asia and elsewhere, and boost its export capabilities, will be crucial. Also, the country's external debt is not going down.

### ***a. Fiscal and Monetary***

In the face of inflationary pressures and a high external debt, fiscal policy will remain tight. The budget surplus will be used to retire a portion of the government's external debt and to maintain fiscal reserves of the central bank. Non-oil revenues, which have grown by an average of 23 percent per year since 1990, are expected to rise by only 13 percent in the near future. In monetary policy, the central bank will further tighten its monetary stance

to counter inflationary pressures and stem the increase of bad loans on the banking sector's balance sheet. The rise in interest rates has had only a limited impact on credit demand.

Restrictive fiscal and monetary policies so far have not been able to contain the rate of inflation, which is likely to exceed the government's target of 9 percent. Strong domestic demand and increased investment will make this containment difficult. Exchange rate policy has sought to balance the twin objectives of inflation control and external competitiveness. To keep exports competitive, the central bank has traditionally guided the rupiah down against the United States dollar by an average annual depreciation rate of about 4 percent. Moreover, the government is expected to intensify efforts to increase the collection of domestic taxes and diversify the tax base. The reduction in the rates of personal and corporate income tax stipulated in the new laws are expected to stimulate a more rapid growth of GDP, and hence of corporate profits and taxable income.

Foreign investment inflows are expected to continue to expand, reducing the need for foreign borrowing and allowing the foreign debt total to ease towards the end of the decade. The continued weakness of the banking system and the growing influence of a small group of politically well-connected business conglomerates may lead to a serious erosion of confidence among foreign investors and increase the risk of social and political unrest (EIU 1996). The government will accelerate its program of partial privatization of state owned enterprises as a means of generating additional revenue to pay off foreign debts and meet its other commitments.

#### ***b. Investment***

Risk for foreign investors will arise from the continued weakness of the banking system, the growing influence of small group of politically well-connected conglomerates, and the risk of political and social unrest. The process of deregulatory reform in particular must place emphasis on liberalizing the still relatively restrictive business and land laws, and curbing the rights of regional governments to vet and approve foreign investments in their jurisdictions.

Efforts to attract increased foreign portfolio investment will continue. The existing limit on foreign equity ownership of companies listed on the local stock markets is

expected to be increased and a large number of Indonesian companies are likely to float their equity on foreign markets. The latter step has already been taken by a number of companies, including the state owned firms expected to follow suit, and include the electricity company, the oil company, and the toll-road operator. Infrastructure needs provide ample opportunity for domestic and foreign investment. Foreign investment will increase in response to the liberalization measure introduced by the government. The bulk of the approved investment projects are targeted to the production of capital goods, raw materials, and components to replace imports. Although the value of domestic investment approvals was down, lower corporate tax rates, less restrictive rules on joint ventures, and continued infrastructure needs and market opportunities are likely to provide the impetus for more domestic investment in the future.

Repelita VI stipulates an annual average real GDP growth of 6.2 percent GDP<sup>3</sup>, with manufacturing forecast to expand at an average rate of 9.4 percent per year, the agricultural sector by 3.5 percent per year, and the remainder of the economy by some 6 percent per year. The achievement of these growth targets is projected to require a total investment of \$ 300 billions. The private sector is expected to account for 70 percent of this investment. To mobilize the amount of private capital envisaged in Repelita VI, Indonesia must create and maintain an attractive economic environment for private investment. This will have to involve a continuing liberalization and deregulation of the economy, and in particular an easing of the remaining controls on investment and trade. The need for such measures has become especially critical in recent years following the emergence of a number of other Asian countries, such as China, Vietnam, Bangladesh, and India, as competitors for foreign investment flows.

*c. Capital Account and Debt*

Indonesia's current account deficit and debt amortization payments will be financed in the near-term by a combination of foreign direct and portfolio investment,

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<sup>3</sup> Repelita VI came into effect on April, 1994. It represented the first five years phase of the 25-year Second Long-Term Development Period.

offshore commercial borrowing, and multilateral and bilateral aid. Foreign direct investment, in particular, will benefit from the improved investment climate established via deregulation. This initiative has opened a number of sectors previously closed to foreign investors. Inflows of foreign capital will increase enough to maintain comfortable level of reserves.

The appreciation of the Japanese yen versus the United States dollar has added to Indonesia's debt burden, already one of the highest in the developing world. The yen revaluation pushed the dollar value of Indonesia's debt over \$ 100 billion. There is a currency mismatch between Indonesia's liabilities and its export receipts. About 40 percent of the external debt is dominated in yen, while about 90 percent of its export receipts are in United States dollars. About half of the external debt is public, and this public debt is at interest rates of about 3.5 percent. Only a quarter of the total foreign debt is short-term debt. Additional borrowing in 1996 will increase the external debt to \$ 107 billion.

Besides the country's heavy external debt and inflation, there are the persisting pressures of the current account deficit. This presently stands at \$ 2 billion per annum or about 2 percent of GNP (Wignjowijoto 1995). The invisible account deficit is bigger, at \$ 10 billion to \$ 15 billion per annum, due partly to heavy repayment and servicing of the external debt, insurance payments, and the repatriation of profits.

#### *d. Growth and Stability*

There are risks attached to the dynamic expansion of the economy. Inflation reached 9.1 percent from year to year, a figure closer to the 10 percent level that would trigger official action. The government plans to use income from privatization to prepay debt, as it has already started to do with the proceeds from Indosat's flotation.<sup>4</sup> Other state companies will follow in a programme of government disposal aimed at boosting and state sector's efficiency and off loading public debt. To maintain the 7 percent growth rate necessary to employ 2.5 million new people each year, the government has called for total of \$ 330 billion over the next five years (Parsons 1995).

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<sup>4</sup> Indosat is a state-owned international telecommunication company.

The need to keep down the foreign debt has lead to the conclusion that three-quarters of the financing of the foreign debt must come from the private sector and be acquired from the capital markets. Accordingly, private consumption will increase from the larger base established as disposable incomes rise in response to higher wages, lower tariffs on consumer goods, and increased labor participation. Also contributing to the strength of consumption will be the continuing expansion of the middle class with its higher propensity to consume goods.

*e. Others*

Inefficiency is still troubling the economy despite efforts made to tackle it. The economy's efficiency rate is still low due to unnecessary costs imposed by almost any economic transaction. The growth of non-oil exports is now leveling off. Exports of textiles and plywood, which are currently the star performers, continue to decline in 1995. Despite a strong capability to generate production such as power, gas, water and telecommunications, the Indonesian economy makes poor uses of its existing infrastructure.

In the services sector and in areas such as banking and finance, financial institutions are capable of mobilizing funds but seem unable to use them properly. The insurance services market is also expanding, but insurance's ability to absorb risks is limited, as also evidenced by the huge reinsurance markets. This creates a heavy deficit in the invisible account. Another weakness in the economy is the distribution of goods and services from producers to consumers is slow; unemployment is refusing to go away and the gap is widening between the rich and the poor, between Java and outer islands, and between the western part and the eastern islands of the Indonesian archipelago.

The major driving forces for the projected 7 percent growth of the economy will be industries involved in such mega projects as infrastructure, especially electricity, water, natural gas, telecommunications, highways, and major upstream industries, such as aluminum steel, olefin, and petrochemicals. These industries in the early stages of their development will definitely be protected. This is to ensure that downstream activities are not subject to foreign-induced supply instability and price volatility. The next industries that will drive the economy forward are those which support the urbanization process such as

public housing, middle and upper middle-class housing, shopping centers, business hotels, offices, apartments , and condominiums.

## **D. PUBLIC SECTOR**

### **1. Background and Rational**

In the period 1949-1965 the Dutch colonial economy was dismantled and new socio-economic and political forces gathered themselves within Indonesia. The power of the state was reconstituted by political forces and used at various times to modify or confront the colonial economic structures and at the same time to protect and subsidize various elements of domestic capital, both state and private. Nevertheless, disengagement from the colonial economy was sought through a strategy of facilitating gradual domestic capital formation within existing structures. However, it had become clear that private domestic capital was unable to provide the basis for capital formation and the leader of the new republic began to turn towards state capital.

By the mid-1950s, the new Indonesian republic was left with two options: a) Either retreat from its nationalist policies with respect to foreign capital and use foreign capital as the main generating force of a capitalist development or b) extending the process of economic nationalization and socialization by expropriating the remaining Dutch enterprises and using the state as the main engine generating industrialization. The indigenous bourgeoisie, including the party clients, supported the gathering momentum to move towards nationalization (Robison 1986, p. 62). By that time, the largest gain was made by the government sector and the expansion of indigenous capital was largely made up of state capital.

In the Economic Declaration of 1963, the principles of Guided Economy that were followed were: first, the co-ordination and regulation by the state of all sectors of the Indonesian economy, (state, private, and cooperative), to ensure the integration of investment and production into the wider social and political goals and needs of Indonesia. State leadership would be provided both in the form of central planning and control over distribution, credit, and production and by direct state investment. Second, this also led to



the destruction of imperialism and the subordination of foreign capital to national social and economic goals. Finally, was the replacement of the colonial import/export economy with a more self-sufficient and industrialized economy. The expropriations were a major blow to foreign capital in Indonesia and fundamentally transformed the structure of the economy.

The State-owned corporate became the largest and most crucial element of domestic capital in Indonesia. To a large degree, the establishment of a state corporate structure was an ad hoc response to the nationalization of Dutch enterprises. State corporations were formed to take over the confiscated enterprises because the absence of a strong indigenous domestic capitalist class. After the counter-revolution of 1965, several new factors brought about a change in the role of state corporation. Again, part of the reason for the continued dominance of state corporate capital also lay in the difficulty of selling off the corporations. Private indigenous capital simply did not have the resources. The importance of state corporations was enhanced in the 1970s when they were used by the state as the core of the new industrialization strategy. Only state corporations were sufficiently amenable to central planning or capable of operation at a loss if necessary in order to achieve the state objectives of major investment in the capital goods sectors, steel, petrochemicals, metal processing, pulp, and paper.

## **2. Categories of Public Enterprises**

The state's intervention in the economy has not been confined to the imposition of regulatory controls, but has involved a considerable measure of direct participation in almost all fields of economic life. Government investment, both in the form of government financed development projects and in the form of equity participation in private sector project, forms a considerable proportion of total investment, giving the state sector a pre-eminent position in Indonesia's economic structure (Hobohn 1987, p.51). Virtually every sector of the economy has at its apex one or more large scale state owned corporations or PEs (Badan Usaha Milik Negara or BUMN).

***a. In the Resources Sector***

PEs in this sector include Pertamina (oil), Timah (tin mining), Aneka Tambang (general mining) and Inhutani (forestry). Essentially they are the means through which the state establishes production and work-sharing agreements with the foreign companies which make the bulk of investments and carry out production. Included in their responsibilities are the collection of royalties and taxes, the allocation of concessions and contracts, and the supervision of domestic supplies.

***b. In the Provision of Infrastructure***

While the bulk of state investment in infrastructure goes through the development budget, there are also major state utilities such as Pekerjaan Umum (Public Works), P.T. Telkom (Telecommunications), and Perusahaan Listrik Negara (Electricity).

***c. In the Banking Sector***

As well as providing central banking facilities, state banks provide the bulk of commercial credit. The original purpose of the banking system was to act as an investment bank in buying and selling securities. Due to the lack of a developed capital market, this was not done. Instead, the banking system invested in many industrial enterprises which were regarded as its subsidiaries. These included house construction, cement plants, automobile assembly plants, etc. The Bank provides financial resources as well as manpower for the management of its subsidiaries. It was reorganized so that the emphasis has been placed more on industrial finance and industrial development.

***d. Types of Public Enterprises***

Further reorganization of PEs took place in 1967. The Presidential Instruction ordered that all PEs be converted into one of the following forms:

- Departmental Agencies: Perusahaan Jawatan (PERJAN).
- Public Corporation: Perusahaan Umum (PERUM).
- State Companies: Perusahaan Perseroan (PERSERO).

Besides the above, there are four additional forms of PE:

- State-owned Banks: Bank Negara Indonesia (BNI).

- Oil and natural gas mining: Perusahaan Pertambangan Minyak Negara (PERTAMINA) Regional PEs: Perusahaan Daerah (PERDA).
- Military Enterprises.

Thus, there are altogether seven types of PEs. The characteristics of the first three types of enterprises include the main objective of PERJAN being to serve the people rather than make profits, while PERUM, is orientated towards more profit-maximizing. Also, PERJAN is to be usually involved in the supply of public services such as state railways and PERUM is more likely to be engaged in production and distribution of goods and services. Secondly, PERSERO are run as a private company. Unlike PERJAN and PERUM which are wholly-owned by the government, PERSERO can be either wholly government owned or jointly owned by the government and private parties, including foreign investors. Enterprises under PERSERO are nationalized business and joint ventures which are mostly in electronics, textiles and plantations.

### **3. Public Enterprises Performance**

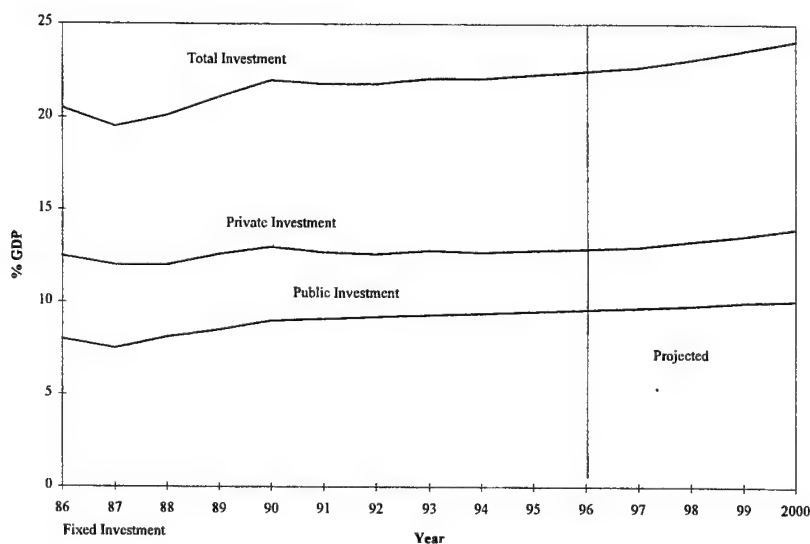
Until recently almost half of the entire PEs performance showed the unhealthy financial condition of requiring large subsidies from the government. From the total of 178 PEs which existed, 86 PEs or 48.3 percent were in “bad”(subsidized) and “very bad” condition (heavily subsidized).<sup>5</sup> In 1995, 49 PEs or 27.5 percent in “very good” condition (profit generating), 43 PEs or 24.2 percent in “good” (condition would attract investment) , 37 PEs or 20.8 percent in “bad” condition, and 49 PEs or 27.5 percent in “very bad” condition. With their total asset reaching about \$ 130.4 billions, Indonesia's PEs can be relied on as a backbone of national economy. PEs in bad and very bad condition will be difficult to optimize. Inefficiency of the PEs for long periods has depressed the economy because their operational area is nearly in every economic sector. The operation are in agriculture, manufacture, mine, trade, financial, telecommunication, electricity, construction etc. More important, some of them operate in strategic and base industries.

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<sup>5</sup> According to Indonesian newspaper *Kompas Online* reported, April 18, 1996.

**a. Public-private Investment Balance**

Indonesia's current gross domestic investment rate is estimated to be about 23 percent of GDP. Investment has grown at an average rate of about 9 percent per annum between 1986-1992, faster than GDP growth (World Bank 1994, p.102). Provided that there is an adequate increase in the national savings rate, private investment should continue to grow rapidly and the overall investment rate in the economy should increase. The investment effort will need to be supported by increased efficiency of investment. Figure 3 shows the projected (Post 1996) increase in the rates of private, public and total fixed investment which must be achieved to sustain a non-oil GDP growth of about 7 percent per annum.



**Figure 3. Total Private and Public Fixed Investment**  
After [Ref. World Bank, 1994 ]

The problem of raising the overall investment rate, improving the efficiency of investment, and raising national savings, lies in promoting private investment and savings. The government has few direct policy instruments to affect private sector decisions. But the principle lesson is that policies that consistently improve the incentives and climate for private investment in internationally competitive activities provide a powerful stimulus for

more and better investment. In turn, this leads to faster growth and increased savings. Private investment is expected to play the dominant role in the directly productive sectors of the economy. Most private investment is expected to go into these sectors. An increasing and significant role is also expected in infrastructure and other public service sectors.

The government should progressively withdraw from directly productive sectors, by limiting fresh investment and undertaking a substantial program of divestiture. Cross country evidence indicates that public enterprise investment is consistently associated with lower aggregate growth and with lower rates of private investment (World Bank 1994, pp. 103-104). Also, large public investment especially on projects that rely on foreign commercial borrowing, should continue to be screened carefully. This would ensure that only those projects that have high economic returns are financed.

***b. Public Enterprise Reform***

Based on a Presidential Decree in 1988, an assessment was made of the financial soundness of each PEs and a program developed for their restructuring. The proposed measures varied from a change of legal status (e.g., from PERUM to PESERO), to mergers, to new management contracts, to joint ventures, to public share issues, and to liquidations. The Government also introduced a system to monitor enterprise financial performance annually, based on an evaluation of the firm's profitability, liquidity, and solvency. The PEs restructuring program introduced in 1989 was ambitious. The aim was to implement the program largely within two years. Its implementation, however, has not met those expectations.

The plan had been for 52 public share issues by PEs and 16 joint-ventures, but only one has been realized in each case. Only one PE has been fully liquidated. Several other liquidation took the form of mergers. Most progress was made in the conversion of PEs into PESERO legal status. During 1989-1991, six PEs were sold fully or in part to the private sector or to PEs employees. The introduction of corporate plans has been slow, their quality in many cases has lacked necessary analysis and strategic orientation, and their links to annual programs have remained weak.

### *c. Recent Performance*

In general, PEs have a decisive role in Indonesia economy. In 1994-1995 they contributed 12-16 percent to GDP, absorbed 1 million in employment, contributed 23.2 percent of state income from their revenue, \$ 1 billion income tax, and have total assets of about \$130.4 billion.<sup>6</sup> Inefficient PEs become more vulnerable in global competition where goods and services trading, including investment flow freely across national borders. In this era, every nation requires the capability to enter the competitive stage, which is tighter, fairer, and more transparent. However, the few studies that have been undertaken have concluded that their economic performance has been very poor. For example, State Electricity Company (PLN) found that it had low standards of technical efficiency and that its tariffs were among the highest in Asia. A study of the State Shipping Company (PELNI) revealed that in its 22 years of operation, it had failed to earn a profit (Hill 1982, p.1016). Both these companies operate in a highly regulated, non-competitive environment.

Inefficient PEs are caused by internal factors such as low management quality and external factors such as bureaucratic intervention. In management and organizational aspects, clear status and mission are essential. Although the PEs realize that in the economy they must strive to succeed and anticipate market demand, in reality it is difficult to create professional management systems to solve that problem. One of the reasons is the ambiguity of the proportional measurement of PEs mission: being an agent of development, an economy stabilizer, and a profit maximizer. Moreover, the status of the employee is crucial. They are government employees as well as a nongovernment employees; this status effects their motivation.

Another constraint in the PEs organization model is hierarchies of many layers. This condition leads to communication and information flow deterioration. This situation creates bureaucrats work systems at all levels of management and managers prefer to maintain their position. Subsequently most of the employees feel no concern for the PEs main mission. Many PEs have no clear objective or strategic planning. Usually the creation

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<sup>6</sup> According to Indonesian newspaper *Republika Online* reported, April 18, 1996.

of a system or a procedure in the company is common sense, so it would seem that which procedure existed only to fulfill administrative requirements and acquire legitimation and information. Traditional management characterized by an irrational and inflexible norm closes the opportunity to creative management and participation.

According to Indonesian Business Data Center (Pusat Data Business Indonesia PDBI), from a sample of 59 PEs in 1993, 25.4 percent PEs were very profitable, 17 percent profitable, 25.4 percent "sick", and 32.2 percent "very sick". Net profit in 1993 was about \$ 1.9 billions, total asset about \$ 113 billion, and turnover about \$ 70.3 billion. The ratio between asset, turnover, and net profit is too small and is not proportional. Profit margins of only 2.74 percent and return on investment (ROI) of only 1.68 percent are too low by private sector standards. ROI can be one of the measurements of a PEs profitability. From this indicator, 23 PEs have ROI of more than 10 percent, 39 PEs ROI of 5 to 9.65 percent, 73 PEs ROI of 1 to 4.91 percent, and 29 PEs ROI less than 1 percent, while 14 PEs are operated at a loss.<sup>7</sup>

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<sup>7</sup> From Indonesian newspaper *Kompas Online* report, April 20, 1996.

#### **IV. PRIVATIZATION IMPLEMENTATION**

Privatization redefines the role of the public sector. Privatization will change the business environment. Sales of PEs will have widespread implications for entrepreneurship, regulatory framework, financial institution, human resources, and foreign investment. Narrowly defined, privatization involves the transfer of ownership control or functions from the public to private sector. However, in the broad sense of the term, it includes any measure that reduces government involvement in economic activities. Thus, privatization is an integral part of the policy package that includes deregulation and economic liberalization.

Dissatisfaction with the performance of PEs on the one hand, and the already strengthened private sector on the other, led the policy makers to take a fresh look at the role of government. After decades of high hopes for state intervention, the time had come to roll back the frontiers of state and to use the private sector as the engine of growth. Privatization is used not only in response to government failure but also as a positive policy tool to assist in industrialization. Privatization does so by creating a competitive business environment that is conducive to productivity, foreign investment, and private entrepreneurship.

##### **A. PRIVATIZATION INTENT**

While the key objective of private enterprises is profit maximization, PEs have to contend with multiple objectives that often conflict with this objective. These include general economic and noneconomic objectives, ranging from social obligation to political patronage. Often, PEs must be kept afloat at taxpayers' expense, either through explicit government subsidies, such as direct cash grants, or through implicit subsidies, such as subsidies credit, guaranteed sales to the government at fixed prices, reductions of tax liabilities, government equity injections, or preferential exchange rates. While there are different ways to improve the management of PEs, privatization is seen as the best means to enforce market discipline and promote an efficient allocation and use of resources. In addition, entire industries have to be restructured to ensure competitiveness and it will be



necessary to introduce regulation and supervision to produce effective competition. Increased competition can be brought to the market place through improvement in efficiency from the benefit of privatization.

### **1. Public Enterprise Performance and Drive to Privatization**

The inadequate performance of PEs has created a heavy fiscal burden in terms of budget deficits and foreign borrowing. PEs, which are characterized by inefficiency and bureaucracy, are incapable of satisfying the demands of high population growth rates and urbanization. There are significant demands for public services and infrastructure. Indonesia needs to raise billions of dollars for physical infrastructure, energy, and telecommunications networks. Moreover, PEs, known for their bureaucratic structure and inefficient management, cannot be relied upon to adopt measures needed to increase their international competitiveness.

Outward looking industrialization and a growing global interdependence have made competitiveness a prerequisite for success. There is a growing need for foreign investment and expertise. Countries have realized that, to be competitive, they must focus on advanced technology and scientific research. Foreign capital and management are welcomed by the PEs that are scheduled for privatization. There is greater support for private sector-led growth, along with the ability and willingness of the private sector to provide public goods and services. Privatization is a policy response to the problems faced by the country. Export bias, the need for new technology, and a growing need - caused by the population growth - for services play an important role in the privatization of the PEs. The common objectives of privatization are to:

- Raise revenue for the government
- Promote competition and efficiency by imposing the discipline of the market
- Widen the capital market through popular capitalism
- Attract foreign capital
- Redistribute income and wealth (Doshi 1994, p.43)

## **2. Finance, Information, and Control**

There are essentially three factors that can justify privatization: finance, information, and control. The financing of both government and the firm is affected by privatization. The government raises finance in the process of disposing of assets; firms are free to finance in capital markets. Information is relevant in the process of setting prices. Competition ensures that prices are consistent with efficient allocation of resources and lowest cost of supply. Where price mechanisms alone are not adequate then control is of relevance. Changes in ownership are most directly associated with changes in control exerted by the state and a transfer of control to private investors.

### ***a. Financial***

An important motive is the anticipated alleviation of the PEs' budgetary burden on the government. The immediate effect will be a one time reduction in the government deficit, equal to the sales value of the assets. However, if the PEs are profitable, its privatization means that the government forfeits the future stream of income. The more important changes in the government's budgetary position will occur if privatization alters the operations of the enterprise. If privatization is expected to result in an improvement in the financial performance, it would be possible to sell loss-making enterprises, provided the anticipated gain in profitability is sufficiently large. In this situation the drain on the government's overall budget is reduced. An improvement in both financial and efficiency performance will occur if privatization is associated with competitive market conditions.

### ***b. Information***

Central to this was the notion that market encourages efficiency by providing incentives to managers and workers. Competition encourages efficiency by allowing consumers to purchase from lowest-cost suppliers. It achieves productive efficiency by encouraging firms to minimize costs and allocative efficiency by bringing consumers' demands in line with marginal cost supply. To the extent that privatization allows state-owned monopolies to be broken up and competition to be introduced, privatization clearly offers considerable scope for efficiency improvements. Previously, PEs which were submerged in the depths of government ministries made accountability for performance

almost impossible to establish. After privatization, distinct enterprises have been created with clearly defined lines of responsibility.

*c. Control*

Control has been transferred from the public to the private sector. In most privatized firms, management has therefore been given a free rein. They improved incentives to perform efficiently; however there is little direct external control exerted by investors. While privatization has reduced the direct involvement of the government, this has in large part been transferred to the regulator. Privatization has conferred considerable powers on regulators to control the activities of privatized firms. The activities and powers of regulators are broadly defined. Most privatized companies have established regulatory departments, whose primary objective is to deter interference from the regulator and ensure that best possible outcomes can be negotiated with regulator.

**3. Criteria and Benefit**

*a. Criteria*

It is helpful to structure the problem as a cost-benefit analysis. In principle, one might examine the effects of each alternative privatization proposal on different interest groups such as existing and potential customers, taxpayers, suppliers of labor and capital, etc. Trade-offs between these interest groups could be established and decisions made accordingly. A single criterion might be used such as the present value of aggregate net benefits to consumers. This is measured primarily by lower prices of currently available goods and services. Effects on the level of output, the quality and variety of goods and services available, and the rate of innovation are also important. Changes in the distribution of benefits and effects on employees, suppliers, exports, and taxpayers must also be considered. Nevertheless, the criterion of aggregate net benefit to consumers seems a simple and appropriate starting point. The criterion of benefit to consumers should be used to design the privatization scheme as a whole. Consider some of the things to be decided in order to write prospectus for floating one or more successor companies.

- The number of companies, the assets and liabilities of each, and their intended aims and scope of business;

- The structure of the industry in which the company will operate, especially the conditions of new entry;
- The regulatory environment, including competition policy, efficiency audits, controls on prices or profits;
- Non-commercial obligations and sources of funding for these obligations;
- The timing of the privatization scheme, including the flotation date and the times at which new competition is allowed;
- Future levels of the government share holding. (Bishop 1995, pp.16-17)

***b. Benefits***

Privatization is seen primarily as a means of improving the efficiency of the enterprises since it limits the scope for political interference in decision making and thus increases managerial incentives, and imposes the financial discipline of private capital markets. Through privatization, an enterprise can gain access to private sector financing, and a private owner may bring access to new markets. If the sale of PEs assets can be attractive to small investors, this will broaden share ownership (Nuskey 1992, p. 6). Also, it can spur the development of domestic capital market and lead to a reduction in public sector deficits, especially if the government can dispose of loss-making enterprises. In addition, it will increase competition and hence improve allocative efficiency. Privatization may also benefit enterprises that remain within the public sector. If a significant number of PEs can be transferred to the private sector, the government should be better placed to focus on the objectives, conduct, and performance of those enterprises remaining under its control.

Subsequently, the criterion involves benefits for two sets of consumers: actual or potential consumers of the industry and other consumers, who benefit from savings in resources which may accompany privatization. If lower subsidies are paid, other consumers will benefit via lower taxation. Subsidies represent real resources which could be consumed elsewhere. Privatization will generate benefits for consumers because privately owned companies have a greater incentive to produce goods and services in the quantity and variety which consumers prefer. Companies which succeed in discovering and meeting consumer needs make profits and grow; the less successful will wither and die.

Resources tend to be used as consumers dictate, rather than according to the wishes of government. Moreover, consumers change the motivation of management toward profit-making; a privately owned company will have greater incentive to exploit monopoly power. A privatized company will be less willing to provide uneconomic services. The resources so released will be used more productively. The benefits of privatization derive partly from the ability to diversify and redeploy assets, unconstrained by nationalization statutes.

#### **4. Competition and Efficiency**

##### ***a. Competition***

Competition is the most important mechanism for maximizing consumer benefits, and for limiting monopoly power. Its essence is rivalry and freedom to enter a market. Different parts of the industry could compete if formed into horizontally separate companies. Resources or assets could be transferred to potential entrants. Vertically separating the industry into different companies would also generate rivalry at the interface. In the absence of competition, one cannot know in advance precisely what industry structure will prove most efficient. Therefore, as far as possible, the future growth of the industry should not be fixed by a rigid pattern such as before privatization. Companies should be allowed to expand or contract, diversify or specialize, as market forces dictate.

The performance of any one firm depends on the actions of its rivals' managements as well as its own. If a management team performs poorly in competition to reduce costs, its market share, power and prestige are all likely to suffer as a consequence. The efficiency consequences of enterprise sales are therefore likely to be dependent upon the degree of competition. Where privatization is achieved by allowing firms to compete for the right to serve a market or supply a good that was previously served or supplied by a protected PEs, competition is immediately increased. Franchising and contracting out are attractive policy options precisely because they possess this property. Moreover, firms can be asked to place bids for the sole right of supply of the given commodity and, to prevent monopolistic pricing, the right can be awarded to the firm that offers to supply at the lowest price. Franchising therefore offers a possible solution to the natural monopoly problem. The

existence of a competitive bidding process will provide the authority with information about feasible costs of provision and create incentives for cost-efficient operation by public sector workers. (Yarrow 1986, p. 335)

***b. Efficiency***

A change to partial or complete private ownership can be expected to lessen the scope for political intervention in the operation of the enterprise. The enterprise's objectives will be simplified, overly complex networks of dysfunctional bureaucratic controls will be reduced, and the likelihood of arbitrary interference in operating decisions will be lessened. Each of this change can be expected to contribute to an improvement in productive efficiency. Internal reform of the PEs are an alternative option for realizing the same gains. The key factor determining the efficiency of an enterprise is how it is managed (Cook 19, p. 19). Altering the structures of property rights will improve the incentives for productive efficiency performance. This supposes that private firms need to perform efficiently to remain in business. The forces of competition should provide the incentive for enterprises to seek out opportunities to increase both productive and allocative efficiency.

**B. PRIVATIZATION PROCESS**

Based on the International Financial Corporation's (IFC, an affiliate of the World Bank) experience of advising, the political and economic goals of privatization are traded off against one another in the privatization process. The tradeoff is shaped by the specifics of the business. It is far easier to insist on rules about employment retention when selling attractive assets where plenty of buyers are interested. The country's economic context is also important. High risk countries limit the access to external finance, while the state of domestic capital markets often limits the flexibility these governments have to achieve distributional goals. The privatization process<sup>8</sup> which consists of an institutional framework

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<sup>8</sup> Alan N. Miller's (Professor of Management in the College of Business and Economics at the University of Nevada, Las Vegas) research in United Kingdom result that there are 12 steps in the privatization process. The process has been used to privatize different size businesses from diverse industries. In infrastructure, there are 6 phases

and approach to the whole program, of how to structure each particular divestiture, the steps that need to be taken in preparation for sale, and how to manage the sale and negotiations are IFC's experiences. (Donaldson 1995, p.19)

### **1. Institutional Framework and Approach**

Privatization is political at all stages, and at the earliest stage, the most political stage of all, the non-economic objectives and concerns are uppermost in people's minds. Signals are often conflicting from different parts of government involved in setting up privatization programs that hold different views. The legal and administrative authority for a decision is not clear. A key approach is that the process be as transparent as possible and as much as possible in the public domain. Specifically this implies the promotion of competition, the mounting of effective information and publicity campaigns, and in the case of smaller-scale work, a grass roots dialogue with the affected public in response to public concerns.

The launching of a privatization program depends on the extent of government strength and commitment. Strong governments have the widest set of options. When political strength exists alongside government commitment to reform, the route to privatization can be top-down, direct and swift. For a privatization program to gain momentum, early sales have to succeed. This suggests privatizing the easy candidates first. Adopting a sectoral approach to privatization can improve efficiency as well as the effectiveness of the privatization process. Depending on the industry and country concerned, the number of enterprises in the sector and the strategic linkages between them, governments can benefit from designing a privatization plan for the whole sector rather than simply following a case-by-case approach.

### **2. Structuring the Divestiture**

Once the institutional framework or broad approach is in place, a series of specific decisions is typically taken relating to how each individual privatization should be structured. In the more complex transactions, the vehicle for this is often a detailed strategic review requiring careful scrutiny, and experience and familiarity with a wide range of business and

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according to Scott Durchslag, Tino Puri, and Arvind Rao.

other issues. Tradeoffs are again involved, often at an extremely complex level of detail. Recommendations may be made concerning: the retention of strategic control by the state; the desirability of strategic restructuring; the allocation of shares to different groups of purchasers; the promotion of competition and the need for regulation; and what to do about social obligation.

The business must define what sort of buyer should be courted. In a small-scale transaction, there is typically no time to consider business aspects or cost. In the larger and more specialized transactions, however, the business needs to drive the design of the transaction much more acutely. A political objective which often conflicts with business need is the desire to spread ownership. Strategic investors may be the only way for business to gain accesses to new management, technology, new markets, training, and investment finance. Privatizing by other means, particularly those involving wide share distribution, may not yield access to these inputs. The strategic review of the business needs of an enterprise also defines a whole set of issues relating to preparation for sale.

Reconciling a buyer's need to be independent with government reluctance to let go is often a key element of the art of privatization. Many governments are reluctant to cede complete control to private investors, particularly foreign investors, in what is deemed to be strategic industries. Purchasers, on the other hand, want to run enterprises their own way and know very well that government is not an ordinary shareholder. Moreover, a pro-competitive structure is an essential part of privatization. There are many ways of achieving a competitive structure. Perfect competition is not always possible, and the best should not be the enemy of the good. Building job target into a sale is sometimes possible, though it can be costly. Governments often insist on a commitment to maintain employment, but other social goals are also occasionally included. For one major assignment, the extensive social obligations of the company together with significant over manning and indebtedness in an industry, leave privatization options limited.



### **3. Preparation for Sale**

In addition to the overall design of the structure of the privatization, advisers and their clients must address a wide variety of more specific issues when they sell enterprises. Included among these issues are, what to do with debt, whether to invest in the PEs prior to privatization, whether to define the scope of future investment, whether to value the enterprise prior to sale, how to manage the transition period, and what policy should be taken on environmental liabilities. Government should and usually does absorb PEs debt before sale. There is rarely any advantage in passing debt across to the private investor because for every dollar of debt, the bid price will be a dollar lower. Furthermore, bid payments are cash in hand now while debt repayments are generally in the future.

Relating to investing before a sale, governments are often tempted to make enterprises more attractive to purchasers before the sale. This logic is often taken much further than mere cosmetic improvements. Substantial renovations and new investments are advocated, intended to transform the enterprise into a modern, well-performing entity. In shaping investment post-privatization, investors will often accommodate government desires for future investment. Most governments want sales to be followed by continued operations not closure and asset-stripping. Setting this as condition of sale is not often a problem provided the enterprise can be made viable. Just as investors are not happy to pay for investments made by government prior to privatization, they prefer flexibility on what to do with the company after it has been bought.

In the area of management and organizational changes, while the main changes to a company's organization and management will occur after the sale, the period leading up to privatization is vital. Enterprises are living things, and deteriorate very quickly once they are "for sale." It is imperative, therefore, not only to complete divestiture as quickly as possible, but also to manage the business well in the interim. While a firm is for sale, key employees doubt the firm's commitment to them, are less motivated, are attracted to alternative employment, and may actually resort to sabotage or stealing if they feel sufficiently threatened. Customers similarly question the commitment of their supplier.

#### **4. Negotiating the Sale**

There are two essential factors to balancing in this case. The first factor is the nature of the business in question, especially the size and complexity, the need for confidentiality, and the attractiveness to potential buyers. Another factor is the value commercial information may have for the bidders, who may be potential competitors. In opposition to the need for confidentiality, however, are government needs to also appear fair. Additionally, there is the damaging effect of hanging a public "for sale" sign on a business and this will generally have an effect on the business' performance and its value.

Maximum transparency maximizes public support for privatization. The more competitive and open a sale can be, the more the public can observe and comment on how politicians have balanced their goals and the public can be reassured that the price is reasonable and the process has been fair. The open public auction is the ultimate in transparency. There are alternative processes such as the controlled auction, the small group negotiation, or the targeted negotiation with a single purchaser. Open auctions are well suited to non-complex situations in which there are many interested bidders, who are separated only by the price offered and where no one bidder uniquely fits the PEs.

Controlled auctions are most appropriate where buyers must make substantial business investigations in order to understand the value of the business for sale, and the number of finalists is likely to be limited. Controlled auctions may begin with the public request for bidders to submit their qualifications, including background and financial capability. Once these are established, the seller may also wish to hold a preliminary bidding round in which indicative financial proposals are made in order to identify serious bidders likely to be finalists. This process of bidder pre-qualification limits the damage which can be done to the seller's business from disclosure of proprietary information concerning its cost, margins, customers, and so on.

The small group negotiation is similar to a controlled auction but has a much looser, undefined structure whose conclusion can be timed by the seller to coincide with a point of maximum negotiating leverage. The process is well suited to situations, where there are a small number of likely bidders and variety of potential transaction structure. Each potential

joint venture partner is offered a proposal incorporating different configurations of the existing business, each proposal value is considered separately. Negotiations are brought to conclusion in parallel to maximize bargaining leverage. Targeted negotiation with a single buyer can have the merit of avoiding a time-consuming and costly competitive process, especially where there is an obvious, eager buyer who will pay a premium to prevent an auction. This type of negotiation also maintains confidentiality.

In closing the sale, selling governments should never underestimate the value of signing definitive agreements. The result of the auction procedure are never fully secured until the winning bidder's cash is in the seller's hands. Once the winner is declared it is difficult to return the runners-up to the bargaining table. So, the winner can position himself to renegotiate the detailed terms and conditions of sale. This can be fundamentally alter the deal, particularly if the seller's position is worsening in the meantime. As a general rule, agreements in principle should be avoided unless there is an overwhelming need for speed or the seller is in a very strong position to force the purchaser to conclude the transaction on the seller terms.

## **C. EVALUATION AND SELECTION**

### **1. Priority**

The PEs should be privatized if the net benefits to consumers from doing so are positive. Which PEs should then be given priority? The criterion indicates those PEs where the consumer benefits of privatization are greatest. There are several approaches to determine the greatest benefit. One of them is a larger PEs offers larger potential scope for savings. That is, if costs and prices can be reduced by an average of  $x$  percent, PEs with a turnover of \$ 2 million offers twice the potential benefit of PEs with a turnover of \$ 1 million. It can be assumed that the PEs with larger assets can offer larger consumer benefits. In other words, priority should be given to privatize those PEs where consumer benefits are likely to be greatest. Potential benefits will depend upon the size (assets) of the PEs.

## **2. Infrastructure Demand**

Another consideration is infrastructure demand. Many developing economies, including Indonesia, face a similar conundrum: rapidly growing demand for roads, power, and telecommunications. Closing this infrastructure gap by implementing a properly-structured infrastructure privatization program, can be a critical catalyst for economic development while also providing highly attractive investment opportunities for both foreign and domestic companies (Durchslag 1994, p. 3). Moreover, infrastructure privatization can have an even greater economic impact, since infrastructure determines the availability of essential industrial inputs like power, as well as providing the means to reach both domestic and global markets via roads, ports, airports, and telecommunication networks.

## **3. BUMN Under Ministries**

From 49 PEs in "good" condition or 27.5 percent of total Indonesian PEs in 1995, Indonesian economy bulletin *Warta Ekonomi* listed 39 PEs under ministry department. Table 1 shows their assets, sales, revenues, and assets turnover.

The PEs in Department of Public Work, Communication and Transportation are related to infrastructure, concern about roads, ports, airports, and telecommunication network development. Based on total assets, the three largest assets are also the PEs in Department of Communication, Transportation, and Public Work, follows by PEs in Department of Mine and Energy, Department of Employment, and Department of Financial.

## **4. Privatization Priority Order of PEs**

The highest priority PEs to privatize is based on the criterion of which PEs offer larger potential scope for savings and concern with infrastructure development. PEs that encompass this criterion and become the highest priority are as follows: first, PEs in the Department of Communication with total assets of Rp. 9,467.52 billion<sup>9</sup> and an assets turnover of 19 percent. Second, PEs in the Department of Transportation with total assets of Rp. 7,923.05 billion and assets turnover of 4 percent. Third, PEs in the Department of Public Work with total assets of Rp. 1,765.75 billion and assets turnover of 15 percent. The

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<sup>9</sup> In billion of Rupiah (Indonesian currency); May 1996: 1 US \$ = 2,340 Rupiah (Rp.)

second priority in order are PEs in the Department of Mine and Energy with total assets of Rp. 2,580.62 billion and an assets turnover of 12 percent, PEs in Department of Financial with total assets of Rp 1,057.69 billion and an assets turnover of 22 percent, and PEs in Department of Agriculture with total assets of Rp. 1,003.47 and an assets turnover of 17 percent. The remaining are in a low category of priority.

Department	Number of PEs	Total Assets	Sales	Revenues	Assets Turnover (%)
Financial	3	1,057.69	507.12	237.3	22
Agriculture	3	1,003.47	686.46	177.72	17
Industry	3	107	59.33	12.75	11
Defense	1	357.37	83.25	16.47	0.46
Forestry	3	702.34	634.68	207.39	29
Information	2	99.61	15.81	3.69	3
Mine & Energy	2	2,103.39	676.4	199.22	9
Public Work	3	1,765.75	478.59	280.7	15
Communication	3	9,467.52	4,615.31	1,123.87	19
Health	3	837.68	770.53	133.13	15
Employment	1	2,750.47	978.36	99.40	3
Trade	3	359.17	410.6	167.49	46
Education	1	42.5	19.58	0.45	1
State Secretary	1	65.6	139.31	2.18	3
Strategic Industry	3	538.44	353.21	13	70.31
Transportation	3	7,923.05	4,067.4	384.39	4

In billion of Rupiah (Indonesian currency); May 1996: 1 US \$ = 2,340 Rupiah (Rp.)

Source: *Warta Ekonomi* November 27, 1995.

**Table 1. Thirty-nine PEs Under Ministry Department**

## **D. MANAGEMENT REQUIREMENTS FOR PRIVATIZATION**

Privatization is not merely a policy measure to revitalize the economy. More fundamentally it represents a refinement or change in government philosophy of the political economy. Privatization is a complex, multifaceted phenomenon comprising diverse options and methods of ownership transfer. Care must be exercised to avoid substituting private monopolies for public monopolies. Although productive efficiency may be prime motive or objective for privatization, market competition also involves considerations of equity and continuing government control. Economic decline or fluctuations, as well as political uncertainties, may constrain, interdict, or delay privatization efforts.

While privatization can be carried out in a very short period of time for some PEs, others may require more time to create the appropriate conditions necessary for success. Privatization should not be viewed as a goal in itself and must be thought of within a more general framework of deregulation and liberalization of the economy. Procedurally, privatization should start out by defining goals, which include the purely technical and economic aspects, as well as the policy-oriented issues relating to property concentration and type of investor. Once goals are set, an analysis of the type of enterprise and its market structure should be undertaken.

### **1. Managing the Economic Policy Environment**

The most important management policy is that of establishing an appropriate set of economic policies for privatization and private enterprise development and managing the economic reforms necessary to support an expansion private sector. Neither domestic nor foreign investors will participate heavily in privatization in countries where economic and political risk are high (Rondinelli 1994, p. 21). The privatization process must create an economic policy environment conducive to the growth of a sound market economy.

The element of economic reform that are necessary to support privatization and private enterprise development include structural adjustment policies to create market mechanisms, financial liberalization and the reduction of price controls. Economic stabilization policies including debt rescheduling, control of the money supply, and reduction of subsidies. This

is related to trade and investment reform, including programs for export promotion, foreign direct investment, exchange rate adjustments, and reduction of investment restrictions and trade barriers. Deregulation in industry and services must allow private enterprise to operate efficiently and effectively without government intervention. Also, government policy changes give an opportunity to multinational corporation to deliver incentive and support for the development of small and medium-sized enterprise.

## **2. Managing the Privatization Process**

Managing the privatization process is complicated. A set of important management principles that clearly identify the objectives of privatization, create an effective privatization agency, select appropriate methods of privatization, and develop clear and transparent procedures are required. Objectives may include increasing efficiency, reducing debt, promoting competition, raising revenues, and budgetary relief. The most effective means to manage the privatization process is to centralize responsibilities for policy making in a single ministry or agent. At the same time, responsibilities for implementation should be decentralized.

Various means are available to privatize PEs. Each method has different characteristics, requirements, advantages, and weaknesses. No single method is the most appropriate for divesting all PEs or eliciting the participation of the private sector in all functions. Governments must choose the methods that are most appropriate for achieving their objective. Transparency must exist in every privatization transaction. Transparency can be achieved by utilizing clear and simple selection criteria for evaluating bids, clearly defined competitive bidding procedures, and adequate monitoring and supervision of the program. Finally, governments should allow for restructuring, liquidation, or bankruptcy of PEs that cannot be sold.

## **E. PRIVATIZATION IN INDONESIA**

Despite making tremendous headway toward creating a market-oriented society, 55 percent of Indonesia's economy is still under state control. The government is committed to ensuring that the state enterprises become profitable under deregulation and a more

liberalized economy. But large companies, such as the national airline, Garuda, must find solutions for major operating inefficiencies before they will be consistently profitable enough or fit for public sale.

A major handicap for the government in its drive to speed the privatization process is the underdeveloped condition of local financial institutions such as banks, securities companies, and mutual funds. This means that the majority of funding must be supplied by foreigners, who currently account for 70 percent of daily trading on the Jakarta Stock Exchange. Recognizing that an ever growing number of enterprises put up for privatization greatly increases the selectivity of investors, the Indonesian government is taking steps to merge state companies into large enough entities to command overseas interest in investment.

The mergers of Gresik, Semen Tonasa and Semen Padang now underway will create the largest cement company in the country, topping Indocement. This new company will serve the less developed areas of eastern Indonesia. Similar moves have been made in shipbuilding and the results may be seen in ports and in the construction sector of Indonesia in the future. Overall, there is cause for optimism. The government was very successful in the privatization of its telecommunications giant Indosat. Indosat was floated in December 1994 on the New York Stock Exchange.

Not so long ago, privatization was a dirty word in Indonesia. Indonesia has suffered during the colonial experience under the Dutch. The idea of selling state companies to foreigners and non-indigenous locals was anathema. As times changed, Wall Street investment bankers have flocked to Jakarta hoping to pick up commissions for steering the biggest and best public sector firms onto the international markets. Bureaucrats, local brokers, and companies have seen the benefits of financial globalization.

Small investors have started buying shares in state-owned companies, this in a country where only six years ago the stock market barely functioned. The market itself has rocketed, achieving a capitalization of US\$ 75 billion and fielding a roster of 232 companies at the end of 1995. This is compared to 53 companies with a capitalization of US\$ 9.6 billion at the end of 1989. The privatization program will change the face of business in Indonesia.



Of the top 10 listed companies on the Jakarta Stock Exchange, four are owned by Indonesians, with a total market capitalization of nearly US\$ 20 billion. By far the largest is Telekomunikasi Indonesia (Telkom), privatized last year with a market capitalization of US\$ 12.4 billion. There is more in the future. Scheduled for listing this year or soon after are Jasa Marga, a toll-road builder and operator; Perusahaan Listrik Negara (PLN), the giant electricity utility; Krakatau Steel; and a profitable state bank, BNI.

Waiting in the wings are airlines, railway companies, plantation firms, chemicals and fertilizer companies, aerospace and shipbuilding firms, banks and finance houses, media firms, more public utilities and the biggest prize of all Pertamina, the state oil company, one of the largest firms in Southeast Asia. For the Indonesian government, the idea that investors in New York and London would line up to buy shares in an Indonesian telephone company was unimaginable at the start of this decade. But investors, both international and domestic, have queued to buy shares in the two telephone companies - Indosat and Telkom - putting a total of almost US\$ 3 billion into the hands of both the government and the companies.

Apart from putting funds into government coffers to support debt repayment, the drive to privatize has had another major effect: it has giving an extra impetus to a push to make the state sector more transparent. Transparency is desperately needed. For years, state-owned companies, whose accounts are not usually published, have been subject to "unofficial costs" and pressure from powerful political insiders, forcing them to take actions or do deals that were disastrous to their operations.

The Director-General in charge of state companies at the Ministry of Finance is likely to push for further development of the Jakarta Stock Exchange through more privatization of state companies. The Director-General is expected to press for foreign investment banks to set up offices in Indonesia before awarding privatization commissions. Indonesia's strategy of pursuing privatization through international markets has been successful. The benefits of privatization and globalization for Indonesia are thus extending well beyond simply putting much-needed cash into the government's pockets. For a country with a long history of state control, combined with a popular tendency to mistrust foreigners, the change has been revolutionary, and many of the benefits are still to come.

The Indonesian privatization is an expansive program with a specific commitment to coordinate privatization strategies to maximize overall efficiency, and to utilize external sources of finance, managerial skills, new forms of technology, and marketing expertise as a means to promote industrialization and growth. The targets are indicative of a long-term commitment to industrialization and diversification using privatization as the catalytic policy instrument for industrial development.

There are a number of distinguishing characteristics from the international privatization experiences, the range of privatization techniques used, the strong symbiotic role of capital market development, and the utilization of the privatization process to promote economic equality amongst social/ethnic groups. Perhaps, the most useful innovation for Indonesia is the creation of an institution tasked with the job of restructuring and privatizing. An inter-departmental committee under the chairmanship of the Economic Planning Unit within the Office of the Prime Minister is responsible for and authorized with planning, coordinating, implementing, evaluating, and monitoring the privatization program. The Director-General office that is in charge of state companies within the Office of Indonesian Ministry of Finance is one of the candidates for the establishment of this institution which will control all privatization process.

Indonesia privatization policy should be characterized by four central themes. First, it is politically driven and guided by measures intended to promote popular participation. Second, the program is highly structured and has developed an extensive institutional capacity to plan and implement transactions. Third, privatization and the role that foreign participation must play a part in the process and be championed aggressively by the government. This top level commitment can create a policy design and implementation atmosphere where innovative approaches involving the private sector can be undertaken. Fourth, the program should focus on utilizing privatization to develop for Indonesia an internationally competitive infrastructure, such as telecommunications, power, highways, and ports. Infrastructure is viewed as vital to achieving industrial country status within the decade.



## V. CONCLUSIONS AND RECOMMENDATIONS

To fulfill human requirements for many different kinds of goods and services takes a particular relationship between producer, consumer, and arranger. A producer can be a unit of government, a voluntary association, a private firm, a nonprofit agency, or consumer himself. The concept of every economic organization is specialization and cooperative production to increase productivity, maintain competitiveness and realize a profit, be it material or social. A perfectly competitive static economy generally assumes that all buyers and sellers know all the relevant prices in the system in order that equilibrium be attained. But, there still remains the problem of the determination of the "correct" prices if the market is not initially at an equilibrium. In the absence of universal omniscience, buyers and sellers must be allowed to explore the market for this correct price.

PEs are enterprises that are publicly owned and must produce private goods, and sell these goods at a price related to cost. In developing economies, PEs have had the role of galvanizing domestic manufacturing activity, providing infra-structural services, or winning and channeling foreign economic assistance. In contrast, lack of market competition, multiplicity of objectives, inadequate monitoring, and non-profit objectives are all less likely to promote cost-saving innovations and cost minimization. Those factors are the predominant sources of PEs inefficiency and subsequent budget deficits.

Sustained robust growth is central to achieving Indonesia's development objectives. In maintaining a stable macroeconomic environment, the main challenge stems from Indonesia's large external debt. The debt burden is heavy and it limits Indonesia's policy flexibility and raises its vulnerability to external shocks. Policies for growth will need to adapt to the evolving nature of the growth process. Success in sustaining the momentum of growth will depend greatly on how effectively Indonesia manages some important dimensions of this evolution. In an increasingly competitive international business climate, raising efficiency and productivity must be the key to sustain the dynamism of economic development.

Efficiency and productivity improvements hold the key the future growth. The critical need is to foster increased competition by opening the economy further to foreign competition, but also by intensifying efforts to remove barriers to competition within the domestic economy. More broadly, raising efficiency and productivity will be essential to realizing Indonesia's growth objectives within the limits of available resources. Inadequate performance of PEs have created a heavy fiscal burden in terms of budget deficits and foreign borrowing. PEs, which are characterized by inefficiency and bureaucracy, are incapable of satisfying the demands of high population growth rates and urbanization. In addition, there is a significant demand for public services and infrastructure. In fact, PEs known for their bureaucratic structure and inefficient management, cannot be relied on to adopt measures needed to increase international competitiveness.

Privatization redefines the role of the public sector. It will change the business environment. Sales of PEs will have widespread implications for entrepreneurship, regulatory framework, financial institution, human resources, and foreign investment. Also, privatization involves not only the transfer of ownership control or functions from the public to private sector, but also includes deregulation and economic liberalization. Moreover, privatization is used not only as a response to government failure but also as a positive policy tool to assist industrialization by creating a competitive business environment that is conducive to productivity, foreign investment, and private entrepreneurship. Increase revenues for the government, promotion of competition and efficiency, widen up the capital market through popular capitalism, attracting foreign capital, and redistributing income and wealth can be offered by privatization.

Various means are available to privatize PEs. Each method has different characteristics, requirements, advantages, and weakness. No single method is the most appropriate for divesting all PEs or eliciting the participation of the private sector in all functions. Governments must choose the methods that are most appropriate for achieving their objective. Most importantly transparency must be present in every privatization transaction. Establishing an appropriate set of economic policies for privatization and private enterprise development, and managing the economic reforms is necessary to support

an expanded private sector. Neither domestic nor foreign investors will participate heavily in privatization in countries where economic and political risk are high. Finally, privatization process must create an economic policy environment conducive to the growth of a sound market economy.

## **A. CONCLUSION**

In Indonesia, a country that has suffered under the Dutch colonialism, the idea of selling state companies to foreigners or non-indigenous locals was taboo. But, as the biggest and best public sector firms go onto the international markets, bureaucrats, local brokers, and companies have seen the benefits of financial globalization. Also, the future is bright with more companies to be privatized. Beyond this wave of privatization, transparency is obviously required for the PEs. Additionally, an expansive program, economic pragmatism, policy themes, and highly structural institutions are needed.

## **B. RECOMMENDATIONS**

Privatization in Indonesia can improve economic growth. With respect to the management of the privatization of Indonesian PEs and economic liberalization, and based on this research the author recommends the following:

- The process of privatization and liberalization should be motivated more by economic pragmatism than ideological consideration.
- Should create one institution which controls all privatization programs.
- Transparency is desperately needed. Privatization in Indonesia should be prompted by expandable programs with a specific commitment to coordinate privatization strategies and to maximize efficiency.
- Privatization policy should be characterized by four central themes: promote popular participation, create highly structural and extensive institutional capacity, foreign participation, and focus on the development of internationally competitive industries.



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